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Economics Imperialism and New Institutional Economics: A Critical Perspective

Master's Thesis

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ABSTRACT

The term "Economics Imperialism" refers to the expansion of economics to other social sciences by studying social phenomena such as intrafamily relations, marriage, divorce, drugs, crime etc traditionally thought to be the subject matter of other disciplines. The views of economists on the subject differ. Proponents emphasise the accuracy and rigour that economics gives to these other subjects through the use of mathematical and econometric models, while opponents 'blame' this expansionism for trying to capture and to 'enslave' the other disciplines through the use of non-realistic and timeless models. The imperialistic state of economics started after the Second World War when economists tried to establish the status of economics as a 'pure' science increasingly distant from the problems of the real world. The formalisation of economics was undoubtedly a catalyst of economics imperialism by strengthening and stabilising the "hard core" of neoclassical economics. Leading figure of this expansionism was Gary Becker through a variety of works analysing social phenomena such as marriage, divorce and crime through rational maximising behaviour.

The emergence of New Institutional Economics was an expression of the new phase of economics imperialism. The New Institutional Economics was seen as an attempt to give the "dismal" science a more social character, by expanding into the broader context of social life. The main representatives of this school are R. Coase, D. North and O. Williamson and basic concepts used are those of neoclassical economics coupled with transaction costs and institutions. Main areas of application are economic history, law and the institution of the firm.

Keywords: *economics imperialism, neoclassical economics, new institutional economics, interdisciplinary science.*

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1. <u>Introduction</u>

> Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing (Marshall 1920:1, cited in Hirshleifer 1985:53).

> Economics is he science which studies human behaviour as a relationship between ends and scarce means which have alternative uses (Robbins 1935:16, cited in Hirshleifer 1985:53).

"So economics is an imperial science: it has been aggressive in addressing central problems in a considerable number of neighbouring social disciplines and without any invitations", wrote George Stigler (1984:306). Economics Imperialism in contemporary economics refers to the application of economic type analysis to seemingly non-economic aspects of life such as crime, law, prejudice, politics, sociology, religion, the family, war, science, international relations, sociology, anthropology and many others. As a phenomenon it is highly associated with the Chicago School of Economics, the Public Choice School and, in general terms, with the application of neoclassical economics (rational choice theory, market analysis, mathematical form, efficiency and equilibrium) to non-economic aspects of social life and to various fields of research and investigation (Davis 2006:7). Economics imperialism was gaining in strength until the middle eighties as exemplified by a considerable number of works such as Gary Becker's *The Economics of Discrimination* (1957) and *A Treatise of the Family* (1981), Antony Down's *An Economic Theory of Democracy* (1957), James Buchanan and Gordons Tullock's *The Calculus of Consent* (1962) and Mancur Olson's *The Logic of Collective Action* (1965) (Maki 2008:2). These works illustrate not only the fact that economics tended to occupy with subject matter of other social sciences, but also that it tries to explain them using economic tools and methods, sometimes adopting assumptions irrelevant to the real world, supposing that individuals always act rationally while pursuing their self-interest. Thus, economics imperialism is a disputable subject especially during the last four decades, as it divides economists between those who support the power of economics and its success in "colonising" other sciences, and those who argue that this expansionism does not represent a healthy evolution of the discipline (Fine 1999:412). Especially concerning the latter, those who argue that the present form of economics cannot explain the complex social phenomena of real life by using the neoclassical economic tools, have tried to solve both the contradictions and the limitations of the mainstream economics through the introduction of institutional, social and historical features to economic theorising. Economics Imperialism as a phenomenon can be divided into two phases. The old phase is related to the economic approach of Gary Becker and the adaptation of neoclassical tools in analysing social phenomena, whereas the second phase is related to the new information economics associated with imperfect information and new institutional or transaction cost economics.

Attention to the institutional environment after the seventies became increasingly important in economic theory and it has deeply enriched our understanding of how economies evolve through time. Institutions have become a basic element of the capitalist economy. An increasing number of economists and politicians recognise the fundamental role of institutions for the proper operation of the market economy. During recent years phenomena such as globalisation, income inequality, differences in economic performance in deferent places around the world, European integration and undoubtedly the current financial crisis illustrate that "moving ahead" cannot be successful and attainable without the proper institutional framework.

Due mostly to the work of Ronald Coase, Douglass North and Olivier Williamson, institutions have now been recognised as being a key factor in explaining differences in performance between industries, regions, and nations. For instance, economic development is no longer regarded as a gradual transformation from local autarky to specialisation and the division of labour. Instead, development is seen as a response to the evolution of institutions that support social and commercial relationships (Bardhan 1989: 1391). Thus economic development depends on the degree to which the potential hazards of trade can be controlled by institutions, which reduce information costs, encourage capital growth and capital mobility, allowing risks to be priced and shared and therefore facilitate cooperation (Klein 1999:461).

According to New Institutional Economics the lack of an appropriate institutional environment which encourages innovation and cooperation is believed to be responsible for underdevelopment in Third World countries. As a result, new institutionalists must explain why some societies suffering from inefficiency of their own institutions do not simply imitate the more optimal institutions of the developed countries in order to approximate those rates of economic growth. To answer this question we need to know when and how changes occur in order to understand the economic performance of a country. Changes that occur may be predictable or unpredictable. Therefore, sources of change differ from society to society and from situation to situation (Hira and Hira 2000:274). Also, according to North (1994:366) economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement. The implication is that transferring the formal political and economic rules of successful Western market economies to Third World and Eastern European economies is not a sufficient condition for good economic performance.

So, the response to whether the expansion of economics signify the creation of a useful interdisciplinary connection through the export and import of contents between economics and other social sciences aiming at the comprehension of the mechanisms that characterise human thought and activity or does economics present itself hegemonically trying to colonise the other disciplines through the use of the neoclassical economic type analysis consist the main purpose of this thesis. The first part presents a historical review of economics imperialism and a synthesis of the different views concerning the pros and the cons of this trend while the second part refers to the School of New Institutional Economics as a part of the new phase of Economics Imperialism and its leading representatives providing in the end the criticism about NIE and some personal remarks and suggestions.

2. The Conceptual Foundations of Economics Imperialism

In earliest times, economics was not distinct from other social sciences. Especially, in classical Greek thought, Aristotle and Plato discussed economic issues in the context of philosophy. In that period, economics was considered the art of family management as the term comes from the synthesis of the words “oikos” (house) and “nomos” (rules), hence “rules of the house”. Diachronically, as production and economy have become more and more complex concepts, new interpretations emerged accompanied by the import of contents from other sciences, especially mathematics and physics. Economic models were then developed in order to fulfill the desire to use an approach more akin to the physical sciences. The beginning of modern economics is related with the names of Adam Smith, Ricardo and Malthus who analysed economic factors in broader contexts. The publication of Adam Smith's *The Wealth of Nations* in 1776 has been described as "the effective birth of economics as a separate discipline" (Wahl 2008:150). The book identified land, labour, and capital as the three factors of production and the major contributors to a nation's wealth (Alessi 1987:54). Thus, economics has gradually turned into a specific discipline in the eighteenth century and since then has become increasingly important. Towards the end of the nineteenth century, the focus of economics changed from macroeconomics (questions of economic growth and income distribution) to microeconomics (the decision of the firm and the individual consumer). During the last four decades economics has expanded its scope of inquiry as well as its sphere of influence. According to the opinion of its adherents practitioners, the progress of economics results from the fact that the use of its rigorous language enables it to explain complicated concepts in relatively simple, abstract terms (Lazear 2000:104). So what are the basic founding principles of modern economics? Over the years, three basic principles have become fundamental in economics. First, economists assume that individuals engage in maximising rational behaviour. Second, economics adheres strictly to the importance of equilibrium as part of any theory and, third, economists place a heavy emphasis on a clearly defined concept of efficiency (Gray 1987:34-36).

As far as the first principle is concerned, rationality is one of the most over-used words in economics. Behaviour can be rational, or non-rational. So can decisions, preferences, beliefs, expectations, decision procedures, and knowledge. There may also be bounded rationality and recent work in game theory has considered strategies and beliefs or expectations to be rational too. Today, economists use and misuse the term "rationality."

Life has always been a problem solving exercise, a trial and error process in a sea of unknowns. By rational choice theory we mean a theory of behaviour based on the assumption that individuals are acting (or acting *as if)* to maximise their utility (Hodgson 2003:12). Indeed, an individual is considered to be a *chooser par excellence* who examines critically the availability of the means in order to achieve her ends, taking into account the "costs" and "benefits" of every action (whereby costs and benefits are taken in the widest sense). The theory of rational behaviour itself had made huge conceptual advances in the period from the mid 1940s, when von Neumann and Morgenstern published their book *Theory of Games and Economic Behaviour* (Hammond 1997:2). In 1957 Anthony Downs published *An Economic Theory of Democracy* in which the neoclassical presumption of rational choice was applied to democratic political systems (Hodgson 1994:24). But it was not until the 1970s that approaches based on rational choice have escaped from their previous confinement with mainstream economics and are now making enormous inroads into sociology as well as political science. However, the standard axioms (scarcity of available resources, competing ends, interdependence of feedback systems) were often heavily criticised, even as a basis for a normative theory. "Much of contemporary rational choice theory in sociology and economics often appears as a theory of everything, thus becoming an inclusive and universally applicable construct that simultaneously explains everything and therefore nothing" (Hodgson 1998:168). So the challenge became how to investigate the foundations more carefully by considering what might lie behind the standard axioms.

The history of imperialist economics also illustrates something else. That the model of economic man has indeed been productive, but only up to a point. As Adam Smith has put it: "We are not ready to suspect any person of being defective in selfishness" [1976 (1759):482] and of course there are his famous lines: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest" [1937 (1776):14]. From the neoclassical era a characteristically strong statement comes from F.Y. Edgeworth (1881:16):

> The first principle of Economics is that every agent is actuated only by self-interest. Economics... explores and tests the implications of assuming that man is a rational maximiser of his ends in life, his satisfactions - what we shall call his "self-interest".

But someone may question whether all aspects of life can be explained solely in terms of self-interest, for example political behaviour. This issue has been debated from the beginnings of political thought. As Roger Master (1978:59-60, cited in Hirshleifer 1985:55) describes it:

> In ancient Greece, the question was therefore already posed with clarity. The pre-Socratics developed a frankly egoistic or hedonistic theory of human nature... Best known from the speeches of Thrasymachus in Plato's Republic, this hedonistic view treats human laws or customs as "restraints" on nature.... Both Plato and Aristotle, following the tradition apparently inaugurated by Socrates, contest this position. For example, when Aristotle asserts that man is by nature a "political animal," he directly challenges the Sophists' assertion that human society rests on contractual or conventional obligations among calculating individuals. Aristotle's view rests on a developmental or evolutionary account of social cooperation.

3. But what exactly is Economics Imperialism?

One interesting question concerns the exact meaning of the term "economics imperialism". The conventional expression used in this literature is "economic imperialism", but this suffers from an ambiguity. The expression denotes both the imperialism of the discipline of economics in the academic realm and the economy-driven imperialism in international relations and the global economy (Fine and Milonakis 2009:7; Maki 2008:8). In this thesis, I will use "Economics Imperialism" to refer to the former in order to keep the two distinct.

So, Economics Imperialism can be defined as the extension of economics to topics that go beyond the classical scope of issues including consumer's choice, theory of the firm, markets, macroeconomic activity, and the fields spawned directly out of these areas. The aim is to explain all or most social behaviour by using the tools of economics. Areas traditionally deemed to be outside the realm of economics because they were not using information from markets or prices are now analysed by the economic imperialist. For example, discrimination against particular groups, traditionally thought of as a perhaps irrational social phenomenon, has been addressed by economists during the past 40 years (Zafirovski 2000:435; Lazear 2000:109; Fine 2002:2062; Buckley and Gasson 1993:1037; Maki 2008:8; Davis 2007:283 and Medema 1997:122). Economics is extended to consider questions that are inside the "black box". For example, economics textbooks historically took the firm as a production function or a production possibilities set which transforms inputs into outputs. Such a theory is based on the belief that the firm has the ability to almost automatically adjust its control variables to better fit its exogenously changing environmental context. However, modern economics examines the structure of relations within the firm, including issues of personnel policy and market strategy that have been until now outside the scope of economic analysis (Davis 2006:6).

Economists generally believe in the "market test". Economics Imperialism can be judged to be successful only if it passes this test, which means that the analysis of the imperialists must influence others. The effort to extend the field measures its success by inducing others to adopt the economic approach to explore issues that are not part of classical economics (political scientists, lawyers, and sociologists come to use the methods of economics to answer questions that are of interest in their fields) (Lazear 2000:136). Fine and Milonakis (2009:8) in their extensive research on Economics Imperialism argue that within the field of economics too much emphasis has been placed on the explanation of market rather than non-market behaviour. As a result, a division of labour has evolved in the social sciences whereby economists apply a rather different set of principles mainly to market behaviour while other social scientists apply a different set of principles to non-market behaviour (Buckley&Gasson 1993:1039).

4. Why did economics begin its imperialistic age so recently?

"In fact, the whole world may be looked upon as a vast general market made up of diverse special markets where social wealth is bought and sold. Our task then is to discover the laws to which these purchases and sales tend to conform automatically. To this end, we shall suppose that the market is perfectly competitive, just as in pure mechanics we suppose to start with, that machines are perfectly frictionless."

(Leon Walras, *Elements of Pure Economics*, 1874:84, quoted in Nielsen& Morgan 2006:95)

Before 1838 the use of mathematics in economics was a rarity. However, in the 1870s, a revolution took place in economics. The new ideas were those of what was later termed the Marginalist[1] school. Writing simultaneously and independently, a Frenchman (Leon Walras), an Austrian (Carl Menger) and an Englishman (Stanley Jevons) were developing the following theory: the price of goods or services instead of reflecting the labour that has produced them, reflects the marginal usefulness (utility) of the last purchase. This meant that, in equilibrium,

[1] By **Marginalism** we denote the use of marginal concepts within economics. Marginal concepts are associated with a specific change in the quantity used of a good or of a service, as opposed to some notion of the over-all significance of that class of good or service, or of some total quantity thereof (Zablotsky 1995:12). The central concept of marginalism proper is that of marginal utility, but marginalists following the lead of Alfred Marshall were further heavily dependent upon the concept of marginal physical productivity in their explanation of cost; and the neoclassical tradition that emerged from British marginalism generally abandoned the concept of utility and gave marginal rates of substitution a more fundamental role in analysis (Ghiselin 1987:21).

people's preferences determined prices including indirectly the price of labour.

This current of thought was not united, and there were three main schools working independently. The Lausanne school, whose two main representatives were Walras and Vilfredo Pareto, developed the theories of general equilibrium and optimality. The main written work of this school was Walras' *Elements of Pure Economics*. The Cambridge school appeared with Jevons' *Theory of Political Economy* in 1871. This English school has developed the theory of partial equilibrium and has insisted on market failures. The main representatives were Stanley Jevons, Alfred Marshall, and Arthur Pigou. The Vienna school was made up of Austrian economists Menger, Eugen von Böhm-Bawerk and Friedrich von Wieser. They developed the theory of capital and tried to explain the presence of economic crises (Ghiselin 1987:23). In this period, the issue of economics imperialism seemed to be irrelevant and did not arise. The hottest topic concerned the method that should be applied to economic thought (induction or deduction) which led to the well-known *Methodenstreit* in 1890 between the supporters of the Austrian School of Economics, led by Carl Menger, and the proponents of the (German) Historical School, led by Gustav von Schmoller (Fine& Milonakis 2009:2).

As subsequent generations of economists sought to develop a more rigorous statement of the theory, they progressively abstracted from the complexities of the real world to focus on the behaviour of idealised variables under highly purified conditions. This abstractness and generality was combined with the increasing use of mathematical language. Among other simplifications, such as the characterisations of both inputs and outputs as perfectly homogeneous and divisible, economists gradually eliminated all institutional arrangements from consideration. No attention at all was devoted to the accumulation of knowledge of the sorts we now call research and development. They assumed that all rights to the use of resources were fully allocated, privately held, and exchanged at zero transaction costs. Simplifications of this nature were necessary if the theory was to be sufficiently general to the deal with the full range of events within its domain (Davis 2006:18).

Two points need to be emphasised. First, these characteristics have set economics aside from the other social sciences both in terms of methodology and assumptions, and also in terms of precluding any prospect of a genuine interdisciplinary rapport between economics and other disciplines (McKenzie 1979: 149). Second, further consolidating the alien character of economics from the perspective of other disciplines, the century following the marginalist revolution has seen the strengthening of the technical and conceptual apparatus with and through which the discipline of economics has developed. Its crowning achievement without doubt has been the general equilibrium theory which remains the focal point for the vast majority of orthodox economics. In short, the marginalist revolution was responsible for taking the social out of the economy (Fine and Milonakis 2009:9).

The whole period between the marginalist revolution and the Second World War was a period of pluralism in economic science and of intense debates between the various Schools that were flourishing in different parts of the world at roughly the same time, be it in the form of marginalism in Great Britain and other parts of Europe, the Historical School in Germany, or American (or old) institutionalism on the other side of the Atlantic (Fine 1997:146). By 1907 Pareto was saying that an economic problem contained only two ingredients: goals and obstacles to their achievement. In his *Essay on the Nature and Significance of Economic Science* Lionel Robbins proposed a definition of economics, the definition being "Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses" (Robbins 1945:16). This definition of economics, well known as the "Robbinsian definition" of economics in terms of ends and scarce means is powerfully scope-expanding. It "opens the door wider" than previous definitions. After all, the ends that men and women seek include not just bread and butter but also reputation, adventure, sex, status, eternal salvation, the meaning of life, and a goodnight's sleep. According to this conception, the scope of economics is not restricted to ordinary market phenomena (Thomson 1999: 427).

5. Formalism in Economics[2]

"Mathematics brought rigor to Economics.

Unfortunately, it also brought mortis"

Kenneth Boulding

Starting from the second half of the 20th century mathematical logic dominates the methods of economic inquiry. Language of models, adopted by the majority of researchers, has a significant effect on the economic argumentation. On the one hand, mathematical logic brings elegance to economics, clarifying the meaning of economic theories and simplifying the process of their communication. On the other hand, formal expression seems to monopolise economic studies, leaving numerous phenomena that lie beyond the limits of mathematics, behind this consideration of economics (Dow 1999:21). Mark Blaug called it the Formalist Revolution because it was marked by an absolute preference for the form of an economic argument over its content (Blaug 2003:147). While some researchers argue that mathematical tools significantly contributed to the progress of economics (Chick, Weintraub, Backhouse, Krugman), others

[2] By **mathematical formalism** we mean a particular way of theorising, described by Leontief (1971) as a formal application of mathematical methods which becomes a goal on its own, crowding out the initial economic problem. Mathematical formalism significantly oversimplifies reality in order to negotiate it into solvable mathematical equations, obeying the rules of quantitative logic (Pogrebna 2005:84).

(Blaug, Fine, Milonakis, Zouboulakis) maintain that mathematics in many ways inhibited the diversification of analytical method of economics generating highly technical and unrealistic papers.

Hundreds and hundreds of pages were written in an attempt to find out how, when and why mathematics entered economics. By the early 1830s economists realised that they could make use of more complex mathematics. The first name to mention in this regard is Antoine Augustin Cournot (1801-1877), who coined and formalised a concept of interactive rationality. Then the development of mathematics in economics was continued by Leon Walras (1834-1923), Francis Edgeworth (1845-1926) and Vilfredo Pareto (1848-1923). Alfred Marshal (1842-1924) summarised previous findings and popularised the optimisation technique in his *Principles of Economics* (1890). The publication of *Theory of Games and Economic Behaviour* by John von Neuman and Oskar Morgenstern in 1944, considered as a "turning point" in the history of mathematics in economics, opened new horizons in the application of mathematical logic and signified a new era in economics (Weintraub and Mirowski 1994:250).

The focal point of analysis diachronically remained the General Equilibrium Theorem, firstly referred to by Walras in 1870 and then by Arrow and Deubreu with their article *Existence of an Equilibrium for a Competitive Economy* published at Econometrica in 1954, which is characterised by Blaug as the "beginning of the sickness of economics". Debreu's commitment to formalism continued with his article *The Theory of Value* (1959) arguing that "an axiomatised theory first selects its primitive concepts and represents each one of them by a mathematical object… Next assumptions on the objects representing the primitive concepts are specified, and consequences mathematically derived from them. The economic interpretation of the theorems is the last step of analysis. According to the schema, an axiomatised theory has a mathematical form that is completely separated from its economic content. If one removes the economic interpretation of the primitive concepts, of the assumptions

… its bare mathematical structure must still stand" (Debreu 1986:1265, cited in Fine 2007:4).

Undoubtedly, it is easy to understand that the decade of the formalist revolution represents a significant point in the evolution of economic theory and in the relationship between it and the other social sciences establishing the neoclassical orthodoxy and leaving the social out of economics. As Fines opines, "Most economists… have little time for the philosophy of economics as an intellectual discipline. They have even less patience with economic methodology. They prefer instead to do economics" (Fine 2007:6).

At this point it should be mentioned that the dominance of the neoclassical formalistic economic approach has affected the way young economists write papers and do research. An investigation conducted in some of the most prestigious economics departments in the world (University of Chicago, Columbia, Harvard, Massachusetts Institute of Technology, Stanford, Yale and Princeton) by Colander and Klamer in 1983 revealed a complete lack of interest of the future economists about the history and methodology of economics. The success in this field comes to those that have good knowledge of mathematics and econometrics. Economics cares more about the formalistic techniques used to explain the stylised models and facts rather than the explanation of problems and phenomena in the real world (Blaug 2001:146). In 2003 this research has been repeated with the same universities. The results were almost the same. The knowledge of mathematical models and econometrics is considered a necessary prerequisite in order to publish a "good job market paper" (Colander 2007:7-15).

Recently, John Hey, previously managing editor of the Economic Journal (one of the best British Economics Journals), observes a change in the method of writing papers in the last decades. There is a "journal game" based on use of irrelevant material and of technical type analysis of every aspect of economic activity. Mark Blaug (1998b:40) opines:

> I am very pessimistic about whether we can actually pull out of this. I think we have created a locomotive. This is the sociology of the economics profession. We have created a monster that is very difficult to stop.

For Blaug, economics in the Western World is dominated by American economics (Americanisation of the discipline), and American economics is dominated by the 4.500 new doctorates seeking employment each year in 3000 institutions of higher learning, in combination with a pressure to publish in prestigious journals in order to gain employment in prestigious institutions with high salaries. According to Blaug (1998a:13) "Modern Economics is 'sick'. Economics has increasingly become an intellectual game played for its own sake and not for its practical consequences".

6. What is the neoclassical "economic approach?"

The neoclassical fundamental assumptions are not open to discussion in that they define the shared understandings of those who call themselves neoclassical economists. Since its inception, neoclassical economics[3] has grown to become the primary take tool of modern-day economics (Weintraub 1998:1840). Although it is now the most widely taught form of economics, this school of thought has many detractors. Most criticism points out that neoclassical economics makes many unfounded and unrealistic assumptions that do not represent real situations. For example,

[3] **Neoclassical economics** is a term variously used for approaches to economics focusing on the determination of prices, outputs, and income distributions in markets through supply and demand, often as mediated through a hypothesised maximisation of income-constrained utility by individuals and of cost-constrained profits of firms employing available information and factors of production, in accordance with rational choice theory. Neoclassical economics dominated microeconomics, and together with Keynesian economics forms the neoclassical synthesis, which dominates mainstream economics after the Second World War (Antonietta Campus, New Palgrave Dictionary of Economics, 'Neoclassical Economics', pp 320-322).

the assumption that all parties will behave rationally overlooks the fact that human nature is vulnerable to other forces, which cause people to make non-rational choices. Therefore, many critics believe that this approach cannot be used to describe actual economies.

Those fundamental assumptions include the following:

1) Analysis is built on the individual.
2) Individuals always maximise their utility.
3) The preferences of the individual are fixed.
4) Individuals are assumed to behave self-interestedly.
5) There is a distinction between normative and positive aspects of a problem.
6) Decisions take place at the margin.
7) The individual's behaviour is explained by concentrating on the charges in the constraints to which he or she is exposed.
8) The results must yield a proposition that can be subject to econometric testing.

The starting point in neoclassical economic theory is its *methodological individualism*. Methodological individualism has been described as the view according to which all social must be accounted for in terms of what individuals think, choose and do (Barghava 1992:1, cited in Tzotzes 2009:5). It is claimed that methodological individualism usually analyses collective action in terms of "rational", utility-maximising individuals. This is the *Homo-economicus* postulate. In this view, the structure and dynamics of most economic institutions can be explained through this concept. However, methodological individualism does not require that the utility function of each individual may be known. In Mises' praxeology, for instance, rational individuals are held to act firstly on their most important needs but individuals don't necessarily have a numerical value for each of their needs (Hodgson 2007:213).

Moreover, the second feature of the neoclassical approach is that the individual or the firm is maximising something, usually utility or profit. The emphasis on maximisation has always been important because it allowed an analyst to make predictions in new situations. The maximum of a function is a well understood concept and a well defined and predictable behavioural response to any stimulus can be derived (Lazear 2000:106).

The third feature of neoclassical economics is what can be called as *methodological instrumentalism:* the view that a concept or theory should be evaluated by how effectively it explains and predicts phenomena, as opposed to how accurately it describes objective reality (Popper 1963:112). Individualistic behaviour aims at the maximisation of preference-satisfaction. Preferences in turn are considered as given, separated from beliefs and moral features. According to Arnsperger and Varoufakis (2006:4) "…methodological instrumentalism's roots are traceable in David Hume's *Treatise of Human Nature* (1739/40) in which the Scottish philosopher famously divided the human decision making process in three distinct modules: Passions, Belief and Reason. *Passions* provide the destination, *Reason* slavishly steers a course that attempts to get us there, drawing upon a given set of *Beliefs* regarding the external constraints and the likely consequences of alternative actions and according to her *Reason* acts in order to fulfill her preferences". It is not difficult to see the lineage with standard microeconomics: the person is defined as a bundle of preferences, a cold-hearted optimiser whose authority does not extend beyond maximising given utilities. She is treated like a black box into which you feed observed data, and through which you produce observable predictions.

Thus, there can be little doubt that neoclassical economics continually and dogmatically reasserts its scientific status and superiority relative to other forms of economic discourse, thereby creating boundaries for definition of the profession, entry conditions, and associated benefits in employment, prestige, financial support and intellectual independence. Admittedly, much of neoclassical economics views the actor as being nonrational or even irrational outside the market and economy, i.e., in politics, religion and other culture, private social life, etc.

In other words, for neoclassical economics in the sphere of social action and society the human agent behaves more as *homo sociologicus*, for example as what some neoclassical economists call *homo religiosus*, *homo eroticus*. Consequently, neoclassical economics is liable to remain alien to the other social sciences to the extent that its analytical roots are recognised and quite apart from its intimidating technical accuracy and statistical methods (Radnitzky& Bernholz 1987:8-9)

However, during the last four decades it is an undeniable fact that neoclassical economics is expanding beyond its traditional boundaries. There are now economic theories of the family, politics, arts, philanthropy and many other social activities. The expansion of neoclassical economics may be interpreted as having a weak and a strong form. The weak form is that, given institutional and other social constraints, individuals behave economically by maximising their benefits or minimising their costs. The strong form goes a step further by also seeking to include the institutional and other social constraints in the framework of analysis. The weak form of expansionism implies that there can be many different models each of which examines different aspects of social interaction by assuming that individuals seek to further their own objectives. The strong form of expansion implies that there is only one true model of economic behaviour. Every aspect of social interaction is simply represented by a sub-model of the general model. The criticism that appears in the literature rejects the view that there can be a general economic model because the basic neoclassical behavioural assumptions ignore biological, psychological and other social realities (Lowenberg 1990:628). That is, economic analysis is not realistic enough to cope with the peculiarities and the complexity of the real world (Nicolaides 1988:317). What is more, to illustrate the limit to the expansion of neoclassical theory, Nicolaides maintains that the neoclassical rationality hypothesis cannot be applied uniformly to all areas of human choice. In order to highlight this important aspect he ground it with an example of a neoclassical model of market interaction in which some sellers are Muslims and derive utility from praying at certain times of day, during which they must close the shop that they have. He claims that profit maximisation is not an appropriate assumption in this case because the Muslim sellers are willing to sacrifice profit for religious observance (Nicolaides 1988:324).

In my view, although the current state of economics is being presented as less dogmatic than the model of perfect competition that it has sought to replace, it has prospered in an intellectual climate in which economics as a discipline has itself become even more intolerant of alternatives.

7. Gary Becker's "Economic Approach"

In recent decades Gary Becker is surely the economist who has done the most to expand the boundaries of economics into the other social sciences, particularly sociology. Sociology arose in the early part of this century as a reaction against individual rationalism.

Becker's unusually wide applications of economics started early. In 1955 he wrote his doctoral dissertation at the University of Chicago on the economics of discrimination. In the early 1960s Becker moved on to the fledging area of human capital whereas in the late 1960s not even crime escaped Becker's analytical mind. The theory struck Becker 40 years ago, when he was running late to examine a doctoral student. With no time to find a free space, he quickly weighed the cost of paying for parking against the risks of being fined for parking illegally. By the time he arrived at the examination, the then-unfashionable idea that criminals would respond to the risks and costs of punishment was taking shape in his mind. The unfortunate student was immediately asked to discuss (He passed, and Becker did not get a ticket). In the 1970s Becker extended his insights on allocation of time within a family, using the economic approach to explain the decisions to have children and to educate them, and the decisions to marry and to divorce (Clement 2002:20). Becker was awarded the Nobel Prize in economics in 1992 for "having extended the domain of microeconomic analysis to a wide range of human behaviour and interaction, including nonmarket behaviour."[4]

Gary Becker's research programme is founded on the idea that the behaviour of an individual adheres to the same fundamental principles in a number of different areas. The same explanatory model should thus be applicable in analysing highly diverse aspects of human behaviour. The explanatory model which Becker has chosen to work with is based on what he calls an "economic approach", which he has applied to one area after another. This approach is characterised by the fact that the individual agents- regardless of whether they are households, firms or other organisations- are assumed to behave rationally, purposefully, and that their behaviour can be described as if they maximised a specific objective function, such as utility or wealth. Gary S. Becker notably argues that ”the combined assumptions of maximising behaviour, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach” (Becker 1976a:4, cited in Hirshleifer 1985:53). It is this approach that has powered the imperialist expansion of economics into the traditional domains of sociology, political science, anthropology, law, and social biology - with more to come.

[4] When awarding the Nobel Memorial Prize to Gary Becker in 1992, the Nobel Prize Committee recognised both versions: the prize was awarded for "having extended the domain of economic theory to aspects of human behaviour which had previously been dealt with—if at all—by other social science disciplines such as sociology, demography, and criminology" (Maki 2008:6).

Becker's applications of his basic model to different types of human behaviour can be accounted for by distinguishing among four research areas: (i) investments in human capital; (ii) behaviour of the family (or household); (iii) crime and punishment; and (iv) discrimination on the markets for labour and goods.

Gary Becker has written in *The Economic Approach to Human Behaviour:* "Indeed, I have come to the conclusion that the economic approach is a comprehensive one that is applicable to all human behaviour, be it behaviour involving money prices or imputed shadow prices, large or minor decisions, emotional or mechanical ends, rich or poor persons, adults or children, brilliant or stupid persons, patients or therapists, businessmen or children" (Becker 1976:8, cited in McKenzie 1979:146). One comes away from reading Becker with the strong impression that he believes that there is no area of human behaviour which is not amenable to economic analysis. In all of his work, Becker assumes that people are rational, which in simple terms means that people know what they want, are able to order their wants from most preferred to least preferred, and are able to act consistently. If people are not in fact rational in all their endeavors, then, for theoretical purposes, they can be treated *as if* they are: That is the essence of the foundation of Beckerian economics (McKenzie 1979:147).

In the early years, this scrutiny was often unwelcome. Many economists believed he was going too far. Social scientists in other disciplines dismissed his views as overly mechanistic. How could economics possibly contribute to an understanding of something as deeply personal as intrafamily relations or as complex as crime? Over time, Becker's initially controversial views became part of modern microeconomics and his methods of analysis are now common practice in many social sciences.

In short, Gary Becker has played a major role in leading the invading force, applying neoclassical economics to a range of non-economic problems. As he puts it himself, "Economics Imperialism is probably a good description of what I do" (Becker 1990:39). Yet, he observes (Becker 1993:xix, cited in Fine 2000:16) "a dozen years ago, this terminology would have been inconceivable". Similar concerns arose with the new household economics: "when I gave my first paper on population, I said I was treating children as 'durable consumer goods'. There was laughter in the audience … as much from the economists as from sociologists and the demographers" (Becker 1990:33).

8. <u>Different Views about Economics Imperialism</u>

As mentioned already, the application of economic reasoning beyond the area of the economy has become generally accepted within the economics profession. For instance, the invasion of rational choice into politics has proved to be a major example of this trend, and this approach is also likely to have a major impact on sociology (Lindenberg 1985:250; Coleman 1990:80). However, there are signs that the easy gains in insights achieved when a paradigm is applied to a new area are diminishing (Hirshleifer 1985: 50). As a result, public choice is no longer as exciting as it used to be, for better or for worse, normality has taken over. Progress on the whole is marginal and the subject becomes more and more standardised. Many contributions are rather mechanistic, while originality and innovation tend to disappear (Frey 1993:95).

So, the contemporary attitude towards economics is divided. On the one hand, there is a considerable optimism about the possibilities inherent in economics. McKenzie and Tullock (McKenzie 1993: 89) for example write: "This new field of research…" referring by this to the fact that economic research after the eighties embodied in its structure an increasing number of social features admitting the significant role that they play for the explanation of a wide range of phenomena "… is ,we think, more exciting, more interesting, and even more relevant than the traditional applications to traditional economic problems". Furthermore, one of the leading representatives of the scholars that support the imperialistic expansionism of the economic discipline is undoubtedly Edward Lazear who in his article *Economic Imperialism (2000)* supported the basic principle of positivism arguing that the power of economics lies in its rigour and that economics is scientific because, firstly, and above all, economics is a science and, secondly, because it follows the scientific method of stating a formal refutable theory based on empirical evidence. What is more, he gives emphasis on the fact that economics is the only scientific discipline among the other social sciences as it succeeds where other social sciences fail to address solutions in central problems of a society. According to him, the goal of economics is to be established as a universal language that will be applicable in a wide range of phenomena (Lazear 2000: 102-103).

More to the point, economics has earned the flattery of imitation by its sister social sciences. Its formal mode of argument, mathematical apparatus and rigorous logic has made it the model for the "softer" social sciences (Heilbroner 1966: 280). Reading Jack Hirshleifer's tribute to the "expanding domain" of economics it is worth highlighting the following statement that indicates the optimism about the tremendous power of economics imperialism:

> It is ultimately impossible to carve off a distinct territory for economics, bordering on, but separated from other social disciplines. Economics interpenetrates them all, and is reciprocally penetrated by them. There is only one social science. What gives economics its imperialist invasive power is that our analytical categories--scarcity, cost, preferences opportunities, etc.--are truly universal in application. Even more important is our structured organisation of these concepts into the distinct yet intertwined processes of optimisation on the individual decision level and equilibrium on the social level. Thus economics really does

> constitute the universal grammar of social science (Hirshleifer 1985: 53).

Economics, according to Hirshleifer's argument, enjoys its imperial status because it presents itself as the "master pattern" of social theory meaning by this that the other social sciences should follow the economic method of evolution and for themselves (Heilbroner 2004: 617).

Furthermore, Ronald Coase whose aim was the study of the world of positive transaction costs, especially the legal system and the rights to perform certain action which individuals possess, argues that the strong export surplus economics maintains in its trade in ideas and methods with the other social sciences is an important indicator of the success of economics. Not much has been said about the source of this success, but it has been attributed largely to advantages offered to other social sciences by the economic type analysis (Coase 1978:209). Further, he continues by boasting of the achievements of the discipline supporting that economics may be judged as the more successful social science because it has explained phenomena within its traditional boundaries better than the other social sciences have explained phenomena within their respective traditional boundaries (Coase 1978:210). In the same spirit Swedberg (1997:164) also reports that:

> The salvation of Economic Science in the twentieth century lies in an enlightened and democratic 'economic imperialism', which invades the territories of its neighbours, not to enslave them or swallow them up but to aid and enrich them and promote their autonomous growth in the very process of aiding and enriching itself.

On the other hand, as far back as the early nineteenth century, economics was called the "dismal science". Udehn for example has drawn attention to the empirical limitations of economics imperialism in other spheres. But his crucial argument is logical rather than empirical: “if the idea that individuals maximise their utility becomes a general and universally applicable 'theory' of human behaviour then it becomes extraordinarily trivial and lacking in content” (Udehn 1992, cited in Hodgson 1994:23).

The problem with the imperialistic trend of economics lies in its high connection with the neoclassical mode of argument which is used to explain social phenomena, or the fact that as Hirshleifer (1985:53) puts it "its analytical categories- scarcity, cost, preferences, opportunities, etc.- are truly universal in application."

In my view, the most significant problem of economics imperialism which exists in its "universal" neoclassical form is that the theory applies only when the conditions of perfect rationality are assumed. This immediately rules out its usefulness in real-life situations. But even where perfect rationality can be assumed, yet another problem arises. The theory now becomes a tautology with absence of operational content. Whatever behaviour emerges in the context of perfect rationality should be optimal, by definition. The economist’s attempt to imitate the natural sciences (of which the assumption of ceteris paribus is an important example) in turn encourages highly formal, even axiomatic representations of the economic process itself. Neoclassical analysis discards all aspects of social interaction that cannot be represented by a hedonic calculus. As a consequence of this act, neoclassical analysis presents itself as being able to apply its theory to such seemingly sociological parts of traditional economic inquiry as the operation of the firm, or of labour markets, or the existence of "sticky" prices, and to extend the economic theoretic to such seemingly noneconomic aspects of society as marriage and divorce, parent-child behaviour, governmental decisions, voting and much much more (Frey 1993: 96).

However, it is highly questionable whether a universal science of society can be built on these principles. On the throne of social understanding sit human beings, endowed with the incomplete and imperfect insights, generalisations, visions, and empirical knowledge by which they seek to reduce the confusion being inflicted upon them. In the non-rational accounts and conceptual formulations by which we try to bring order into this chaos, economics can play an important role, but never a final or definitive one.

Lastly, Fine (2002a:190) argues that what Lazear tends to overlook are the recent developments within the discipline which had made economics more acceptable to other social sciences. The diminishing marginal returns of the "imperialist programmes" of economics applied to other social areas as well as the limited impact on policy-making suggests that the time has come for a change in direction. It is time now to embark on a new course and to switch from an exporter to an importer of ideas. The social and literary sciences contain many ideas which can enrich economic research. The areas of behavioural anomalies and human motivation are two fields where political economy can benefit from insights from psychology; and discourse and personal embeddedness are aspects which economic theory can learn from philosophy and sociology. So we can see that many other concepts and ideas can fruitfully be borrowed from other social sciences.

9. From the Old to the New phase of Economics Imperialism

The Old Economics Imperialism can be characterised as a theoretical approach that indentifies the economy with the market considering the broader social and political background as given. If we accept this assumption, (that the social is considered to be a non-market parameter) then we arrive at the conclusion that a large part of economics remains unexamined although the knowledge of "social" is important for the understanding of how societies work. As it has been noted already, the Old phase of Economics Imperialism represents an outgrowth of the establishment in the discipline of the mainstream microeconomic technical core that has its roots in the marginalist revolution (Fine 2001:155). Formalism played an important role to this establishment, as the assumptions and methods being used included terms like 'production', 'inputs', 'outputs' which were timeless and universally applicable in order to address socially and historically specific contexts. The old phase was highly associated with the name of Gary Becker who notably tried through his "economic approach" to expand the use of economic tools to other social sciences. Becker has achieved considerable success not only within economics as a Nobel Prizewinner but also in other disciplines (Fine 2000:13). But apart from this success, antipathy to Becker came from the fact that he did not go far in understanding human action as it was supposed that individuals act "as if" they live in a world of zero transaction costs, full rationality, certainty and complete information.

Until 1970 the profession was not ready to change. Akerlof's classic paper *The Market of* Lemons[5] has been rejected by both the *American Economic Review* and *The Review of Economic Studies* for being insignificant, while

[5] "The Market for Lemons: Quality Uncertainty and the Market Mechanism" is a 1970 paper by the economist George Akerlof. It discusses information asymmetry, which occurs when the seller knows more about a product than the buyer. Akerlof, Michael Spence, and Joseph Stiglitz jointly received the Nobel Memorial Prize in Economic Sciences in 2001 for their research related to asymmetric information. Akerlof's paper uses the market for used cars as an example of the problem of quality uncertainty. There are good used cars and defective used cars ("lemons"), but because of asymmetric information about the car (the seller knows much more about the problems of the car than the buyer), the buyer of a car does not know beforehand whether it is a good car or a lemon. So the buyer's best guess for a given car is that the car is of average quality; accordingly, he/she will be willing to pay for it only the price of a car of known average quality. This means that the owner of a good used car will be unable to get a high enough price to make selling that car worthwhile (Akerlof 1970:493-496).

the reviewers for *Journal of Political Economy* rejected it as incorrect, arguing that if this paper was correct, then no goods could be traded. Only on the 4th attempt did the paper get published in *Quarterly Journal of Economics*[6] (Azar 2004:273).

By the 1990's Economics Imperialism took a new form, and a revolution around economics occurred. More and more economists came to the conclusion that assumptions of models should be more realistic taking into account factors such as uncertainty, market imperfections and asymmetric information. The new theoretical approach gave rise to new applications such as the new political economy, the new informational economics, the new households economics, the new institutional economics, the new developmental economics, the new economics of crime and so on. For economists the starting point is a perfectly working market which is then reconstructed with a social content in the light of market imperfections (Fine and Milonakis 2009: 57).

One significant part of this new phase as it was stated above, is based on the assumption that within an economy incomplete information and informational asymmetries not only exist but also play a crucial role in the economic performance. The term "new information economics" was coined by Stiglitz and it was based on the idea that market imperfections are the outcome of imperfect and costly information. All these things provided explanations of economic and social phenomena that otherwise would be hard to understand.

Information has special characteristics. It is easy to create but hard to trust. It is easy to spread but hard to control. It influences many decisions. Stiglitz (1994:5) is claiming that this new approach is different from the old one because it enhances the understanding of how markets work and that if markets do not take into serious consideration the crucial

[6] Today, the paper is one of the most-cited papers in modern economic theory (more than 5,800 citations in academic papers as of July 2009).

role of information, then markets would not produce efficient Pareto outcomes. He argues (1994:6) that:

> During the past fifteen years, a new paradigm, sometimes referred to as the information-theoretic approach to economics... has developed... This paradigm has already provided us with insights into development economics and macroeconomics. It has provided us with a new welfare economics, a new theory of the firm, and a new understanding of the role and functioning of financial markets.

In the old paradigm, perfectly informed firms and consumers interacted with each other in perfectly competitive markets. Although it was admitted that there was imperfect information they talked about the information efficiency of markets. There was the hope that a world with information imperfections would be "close to" a world with perfect information.

In the new paradigm, even a small amount of information imperfections can have large effects. Asymmetries of information are one important form of information imperfections. When we talk about informational asymmetry we mean that different people know different things. As Stiglitz (2002:472) summarises in his Nobel Prize Lecture:

> Information Economics represents a fundamental change in the prevailing paradigm within economics. Problems of information are central to understanding not only market economics but also political economy … [enabling me to] explore some of the implications of information imperfections for political processes.

What is more, this phase highlights that there is a connection between the market failures and the lack of social and behavioural features until now in the economic theories. Social structure, the institutional framework, history and customs play now a vital role to the examination of the economic realm (Fine and Milonakis 2009:58).

9.1. New Institutional Economics as a part of the new phase of Economics Imperialism

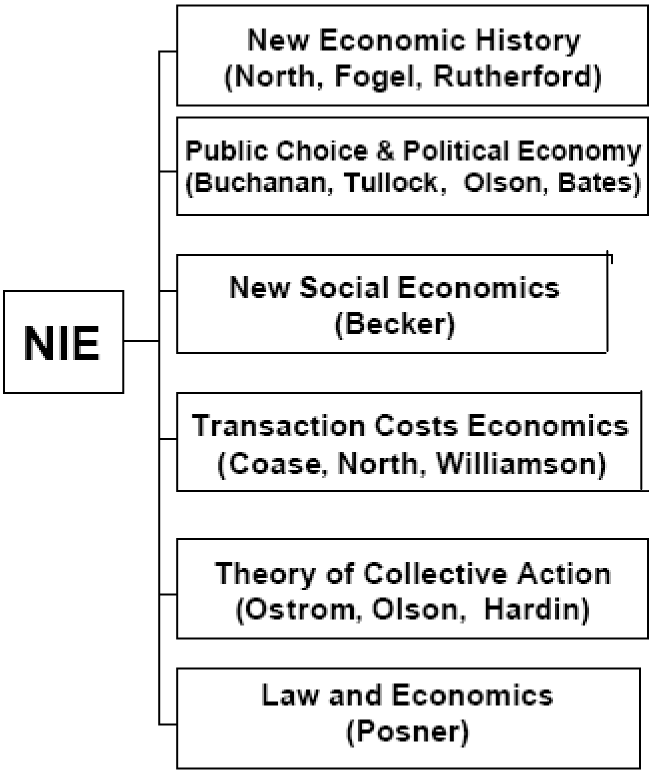
All these among others, were the central topic of the New Institutional Economics which as it was mentioned already consisted a part of the second/new phase of Economics Imperialism. Culture, customs, norms, habits are no longer considered as exogenous or given. In shifting from a world of market perfection to a world of market imperfection, the new institutional approach reflects the ability to accept the existence of both rational and non-rational behaviours as the consequence of markets imperfections. Another important aspect of this new phase concerns the field of development studies. According to the Old Economics Imperialism, development across different countries was considered to be the outcome of market and non-market failures. Now NIE in this new phase suggests that development is a dynamic process in which traditions, customs, and in general the whole institutional framework plays a vital role in a region's development and many times explains the differences in the economic performances between countries. Hoff and Stiglitz (2001: 391-392) argue that:

> In leaving out institutions, history, and distributional considerations, neoclassical economics leaves out the heart of development economics. Modern economic theory argues that the fundamentals are determinants of economic outcomes... even without government failures; market failures are pervasive, especially in less developed countries.

It is not difficult to understand the imperialistic approach of NIE to the other social sciences. NIE can be considered as a large metropolitan area with the "suburbs" expanding rapidly in all directions- into politics, law, sociology, etc. It is the use of economic-type methods in politics where economists and political scientists have created the growing field of collective choice (or positive political theory), and it is in the study of law that the ideas from economics led to the major field of “law and economics”. Economists’ ideas and methods also found their way into sociology, demography and into studies of the family and crime. Whereas economists traditionally studied prices, quantities and fluctuations, they now also study the governance structures and dispute - resolution mechanisms of societies. It is to these studies that the label “New Institutional Economics” is attached.

As a result of the expansion of economics into other social sciences, primarily law, politics and sociology, NIE includes several branches. Fields such as the so-called “new economic history” and the public choice school inform the institutional environment at the macro level while transaction cost economics and information economics for example inform more the micro analytical aspects of transactions and the forms of governance. Figure 1 gives a graphical depiction of the fields in which NIE has expanded and the main academic contributors to each.

Figure 1: Branches of New Institutional Economics



A few words about some of the above branches:

At the turn of the 1960s a New Economic History, sometimes referred to as cliometrics, emerged in the United States. The new approach involved the systematic application of economic theory and quantitative methods to economic history. It was facilitated by the existence of a large stock of quantitative data produced by various agencies, advances in computer technology that fostered the collection of large historical samples. Prominent among the new economic historians were Robert Fogel, Douglass North and Malcolm Rutherford, noting that the two first won the Nobel Prize for Economics in 1993. Public Choice and Political Economy is a branch of NIE illustrated in the early work by Buchanan and Tullock (1962) on the economic analysis of political systems and political decision-making. Concerning New Social Economics, the work of Becker, as it was mentioned already, on intra-household analysis, family economics, and human capital was a major breakthrough in explaining choices that were outside the market and that were previously not addressed by neoclassical economics. The theory of Collective Action includes work by Olson on collective action through interest groups. It is a useful tool to analyse how to overcome the free-rider problem and come up with cooperative solutions for the management of common resources or the provision of public goods (Torok 2005:57). What is more, the application of economic analysis to the study of laws and regulations has led to an important field termed "Law and Economics". The most famous contributor to the law and economics literature is Posner (1971, 1974, 1984, 1998). Posner studied regulations, litigations, and legal decisions using theoretical economic approach. Players in the legal system are viewed as rational actors who attempt to maximise their returns from legal action and regulations (Posner 1984: 132).

10. The History of Institutional Economics: From the OIE to the NIE

The term "institutional economics" has been applied to an increasing variety of approaches or schools of thought. Specifically, "Institutional Economics" or "American Institutional Economics" or "Old Institutional Economics" (OIE) was associated with the works of Thorstein Veblen, John R. Commons, Wesley Mitchell and Clarence Ayres. In recent years the term "New Institutional Economics" has become associated with the work of Ronald Coase, Oliver Williamson, and Douglass North (Zimbauer 2001:4).

10.1. <u>The Foundations of the Old Institutionalism</u>

The term "institutional economics" was first brought to the general attention of the economics profession by Walton Hamilton (1919) in an American Economic Association conference paper entitled "*The Institutional Approach to Economic Theory*". According to Hamilton (1919:312) " 'institutional economics' alone meets the demand for a generalised description of the economic order. Its claim is to explain the nature and extent of order amid economic phenomena, or those concerned with industry in relation to human well-being". It should be noted here that work on institutions has started earlier mostly through the work of the leader of the Old Institutionalist School Thorstein Veblen whose major works appeared between 1899&1904. Veblen's work gave emphasis on the cumulative and path-dependent nature of institutional change, the role of new technology in bringing about institutional change and on the fact that institutions embody generally accepted ways of thinking and behaving. According to Veblen (1907:438) institutions are defined as the "settled habits of thought common to the generality of man". Veblen's theory was based upon Darwinian principles and new ideas emerging from anthropology, sociology, and psychology and described economic behaviour as both socially and individually determined considering economic organisation as a process of ongoing evolution. This evolution was driven by the human instincts of emulation, predation, workmanship, parental bent, and idle curiosity (Brette 2003:456). His best-known works were *The Theory of the Leisure Class* published in 1899 in which people, rich and poor attempt to impress others and seek to gain advantage through what Veblen coined "conspicuous consumption" and the ability to engage in "conspicuous leisure", *The Theory of Business Enterprise* published in 1904 in which Veblen employed his evolutionary analysis to explain these new forms considering them as a consequence of the growth of industrial processes in a context of small business firms that had evolved earlier to organise craft production and *The Instinct of*

Workmanship published in 1914 in which he tried to investigate the human propensities or impulses. What Veblen offers in the three books- especially in *The Theory of Business Enterprise* and *The Instinct of Workmanship*- is a theory of economic development and change, based on the dynamic interplay between human instincts, technological advance and institutional change (Milonakis and Fine 2009: 166-172).

Other important representatives of the old institutionalism were John R. Commons and Wesley Mitchell. For Commons (1950:118-119, cited in Milonakis and Fine 2009:176) the basic unit of analysis for institutional economics is the transaction which he describes as 'the smallest unit we can find which permits the analysis of all dimensions of the human will in action, with the correlated social relations' and Wesley Mitchell in turn was deeply involved in the early development of institutionalism as a definite movement along with Walton Hamilton, Walter Stewart, and John M. Clark.

Old Institutionalism, as a movement, emerged as a response to the aftermath of World War I, highlighting the necessity and urgency of two factors, factor one being the improved economic data and factor two being the role played by the government (Commons 1931:649). The institutionalist movement made a number of positive contributions during this period. Firstly, they took the issue of improving economic measurement seriously. Secondly, institutionalists made contributions to a number of key debates in economics on issues such as psychology and economics, law and economics, business cycles (Mitchell 1935:637). More specifically, in the area of psychology and economics, J. M. Clark's (1918) essay "*Economics and Modern Psychology*" is especially noteworthy presenting a more modern work on decision-making costs and bounded rationality. Law and economics has been another field in which many institutionalists such as Hamilton, J.M Clark, John R. Commons, and Robert Hale made significant contributions. Indeed, Commons's classification as an institutionalist grew out of his 1924 book *The Legal*

Foundations of Capitalism (Burns 1931:82). More generally, the institutionalist interest in law and economics covered topics such as the evolution of property rights, the legal context of transactions, valuation of public utilities, many issues in labour law, collective bargaining, health and safety regulations, and consumer protection. Finally, old institutionalists made important contributions to policy in the development of unemployment insurance, workmen's compensation, social security, labour legislation, public utility regulation, agricultural price support programs, and in the promotion of government "planning" to create high and stable levels of output (Rutherford 2001:178).

10.2. Old Institutionalism after 1945

After World War II, institutionalism in American economics did not live to its expectations losing its influence and prestige. Institutionalists failed to develop their theories of social norms, technological change, legislative and judicial decision-making, transactions and forms of business enterprise in a clear and understandable way. At the same time, mainstream economics gained ground with the rise of econometrics and of mathematical models. Institutionalists could no longer claim greater "scientific" status because of their empiricism (Knight 1952:50). Under these circumstances it is not difficult to see why institutionalism gradually slipped from a central part of American economics it enjoyed before the war to a marginalised position (Rutherford 2001:182-4).

Up to the mid 1970's, the neoclassical tradition, stronger than ever, has been evolved by adopting a non-institutional and asocial approach to economic analysis. The basic underlying legal institutions that were necessary for the existing market structures were simply assumed to exist and to operate in a world of perfect information and zero transaction costs. Basically, the best example of this trend was the perception of firms as "black boxes" characterised by production functions and their technological features input and output. There was a poor understanding in economic-growth differences between countries over time and space. While it was admitted that governments could operate either to improve or undermine economic performance, alternative government policy initiatives were usually ignored (Joskow 2004:2).

11. The New Institutional Economics

Although institutionalism was in decline in American economics the limitations of neoclassical economics were also widely recognised by a growing number of scholars who tried to deal with them through their research. The most obvious outcome has been the emergence of "New Institutional Economics" (NIE), consisting in large part of transactions cost analysis, property rights, contracts and organisations. The New Institutional Economics is a relatively new theoretical approach that has received increasing levels of acceptance among social scientists (Hira and Hira 2000:267). Indicative of this acceptance of NIE is the increasing number of new institutionalists that have won the Nobel Prize such as Ronald Coase in 1991, Douglas North in 1993, Elinor Ostrom and Oliver Williamson in 2009.

NIE as a School of Thought has a historical basis, which can be traced back to the tradition of classical liberal political economy. As two new institutionalists claim:

> The exponents of modern institutional economics apply the analytical apparatus of neoclassical theory (and newer techniques) to explain the workings and evolution of institutional arrangements and thus to expand the scope and predictive power of microeconomics (Furubotn and Richter 1997: 2).

New institutionalists reject the idea of perfect information and hence the concept of full rationality in favour of the concept of bounded rationality.

This concept illustrates that in the presence of uncertainty, information problems and transaction costs economic agents cannot gather all the necessary information to calculate the optimal solution on the market. To minimise the problem of uncertainty economic agents become 'rule followers' meaning that they obey the rules being imposed upon them (Vanberg 1994:32).

Generally, it is argued that it would be more appropriate to use the terms "economics of institutions" instead of "institutional economics". In any case, the term "NIE" defines various kinds of economic explanations of institutions. Next to Ronald Coase, who first realised the institutional consequences of transaction costs, Oliver Williamson and Douglass North are the leading representatives of the NIE. All stress in various degrees the importance of transaction costs, uncertainty, imperfect rationality and methodological individualism (Richter 2005:183).

11.1. <u>Definition</u>

To begin with, New Institutional Economics is an economic perspective that attempts to extend the scope of economics by focusing on the social and legal norms and rules that underlie economic activity (Brousseau and Glachant 2008:xxiv). NIE has its roots in Ronald Coase's fundamental insights in the *The Nature of the Firm (1937)* and *Problem of Social Cost (1960)*. The term 'New Institutional Economics' was coined by Oliver Williamson in 1975 in his book *Market and Hierarchies.* It became soon a catchword for economic analysis and for institutions in general. The many concepts/aspects that are often taken into account in current NIE analyses include: organisational arrangements, transaction costs, modes of governance, social norms, ideological values or belief systems, decisive perceptions, enforcement mechanism, asset specificity, human assets, social capital, asymmetric information, strategic behaviour, bounded rationality, opportunism, adverse selection, moral hazard, contractual safeguards, surrounding uncertainty, monitoring costs, hierarchical structures, bargaining strength, etc (Richter 2001: 10). Other major scholars associated with this School are Harold Demsetz, Avner Greif, and Claude Menard. In 1997 they founded the International Society for New Institutional Economics (ISNIE) (Greif 1998: 81-82).

So, NIE can be considered to be the application of the 'economic language' to other disciplines such as law, organisation theory, political science, sociology and anthropology aiming at the understanding of social, political and commercial institutions. As a matter of fact, New Institutionalism can be thought as the outcome of the Chicago School's "Economics Imperialism" -- i.e. using Neoclassical economics to explain areas of human society normally considered as lying outside it scope. In this sense, New Institutionalism can be seen as the exact opposite of the old American Institutionalist School, which tried to incorporate into economics the reasoning and insights of other social sciences (Peukert 2001:97).

In New Institutional Economics, the focus is on the explanation of institutions by the use of well-known basics of economic understanding: the utility maximising individual placed in well- specified environments produces efficient outcomes (Williamson 1997:3). Methodological Individualism remains the core assumption of NIE as in neoclassical economics, making the individual with given preferences the fundamental foundation of the theory. Although preferences in reality are influenced by the institutional environment, for the purpose of economic inquiry it is considered proper to start the analysis with the abstract maximising individual (Groenewegen, Kerstholt and Nagelkerke 1995:467).

11.2. Institutionalisms: Old and New

There has been a considerable concern among new institutionalists to differentiate themselves sharply from old American institutionalism (Langlois:1986; Eggertsson:1990, cited in Rutherford 2001:187). There clearly are major differences in methodology, in the theoretical and analytical tools used, as well as in the basic orientation towards the market and "business" institutions. One line of connection between the old and the new can be found in Williamson's remarks about the sources of his ideas on transactions cost economics and organisations (Williamson and Masten1995:57).

As far as their differences are concerned, for old institutionalists the predominant factor in shaping institutions has been technology. As technology evolves, new forms of social structure are bound to emerge, always accompanied, however, by conflicts. Old institutionalists believe in path dependency (the importance of historical context), the autonomy of institutions[7], evolutionary economics, and a holistic approach to economics, that is, one that considers cultural and political factors of motivation, interaction, and organisation (Hira and Hira 2000:268). The fact that this approach is open-ended and multidisciplinary makes it simultaneously “rich in content and relatively low in rigour” (Caldwell 1982:186, cited in Groenewegen; Kerstholt and Nagelkerke 1995:469).

OIE has given emphasis on the institutional framework in which an economy operates and how the economic behaviour of the individual is influenced by the general level of social institutions, ethics, norms and traditions. As a school of thought it is against the neoclassical approach and against Marxism, suggesting an alternative framework in which an economy can perform in an efficient way. Specifically, it denies the abstractions of neoclassicism, highlighting the uniqueness of the

[7] The autonomy of institutions means that they are able to affect distribution of resources, rather than simply reflect it.

individual's preferences. It is opposed to the *laissez-faire* and it supports social regulations in order to have a more proper income distribution (Samuels 1984:212).

New institutional economics, on the other hand, emphasises the role of institutions as the most important catalyst of the economic growth and development. It starts from some neoclassical assumptions such as the idea of individuals as maximising agents, develops a theory of institutions as a set of constraints that by regulating human behaviour allows markets, and so economies, to reach a higher efficiency level.

The basic difference between Old and New Institutional Economics is their different methodological approaches. New Institutionalism begins with the principle of methodological individualism, meaning the interpretation of collective actions as the aggregate of individual's actions being formed in a specific moment of time whereas Old Institutionalism adopts a holistic approach of social phenomena.

But, why did the older institutionalist school fail, though it contained such able analysts as Thorstein Veblen, J.R Commons and W.C Mitchell? I assume because NIE occupied and tried to give answer not to traditional subject matters but to topics such as why economic institutions emerged the way they did and not otherwise, how they evolved and how they affected behaviours and the performance of societies in general. Summarising, it can be said that Old Institutional Economics rejects the assumption of *homo economicus* and adopts a theory of man as being culturally formed by institutions (Copeland 1951:56). On the other hand, New Institutional Economics is a school of thought that considers property rights theory to be the most important 'engine factor' for development, and sometimes as an authorisation for the whole institutional framework. Also, there are different perceptions between the OIE and the NEW regarding the definition of the market, the role of the state and of the policies adopted in determining economic outcomes. Whatever institutionalist approach is adopted, institutionalism studies the deeper determinants of economic evolution (Lowenberg 1990:621).

11.3 The Fields of New Institutional Economics

As mentioned earlier, there is still some debate as to what falls under the NIE banner but there seems to be some agreement that the study fields listed here are part of the NIE. The term "new institutional economics" became more widely known around 1980[8] and after then appears increasingly in titles of journal articles, books, papers in collective volumes or conference issues. The following table will help us to understand and will confirm this increase.

Table 1 Fields assigned by editors of collective volumes on the NIE[9]

	Furubotn/ Richter (1984)	Langlois (1986)	Nabli/ Nugent (1989)	Harriss etc. (1995)	Drobak/ Nye (1997)	Clague (1997)
TCE	X	X	X	X*	X	X
Property Rights	X	X	X	X*	X	X

[8] Leonard Silk mentioned the word in the New York Times of September 24, 1980 as a possible "new direction that will gradually draw economists away from their tired repetition of stale and sterile arguments" (Richter 2005:164).

[9] (* transaction cost and property rights mentioned implicitly by emphasising Coase [1937, 1960] and North [1993]: **Furubotn and Richter dropped this field in their subsequent eleven collective volumes). See: http://uni-saarland.de/fak1/fr12/albert/mitarbeiter/righter/institut/waller.htm

Evolut. Econ.	X**	X				
Public Choice Political Econ.				X	X	
NIEH				X	X	
Modern Austrian		X				
Constitut. Choice	X					
Collective Action			X			X
Contract Theory			X			X

Table 1 shows the nine modern institutional economic fields which were mentioned as part of the NIE. These theories were developed by different scholars during the 1960s and 2000s and they are:

- Transaction Cost Economics (Coase, Williamson)
- Property Rights Economics (Coase, Alchian)
- New Institutional approach to Economic History (North)
- Evolutionary Economics
- Constitutional Choice
- Collective Action Theory
- Economic Contract Theory
- Modern Austrian Economics

Certainly, these six collective volumes and their editors cannot be considered as a representative sample but they can reflect the prevailing view of which fields should be considered as a part of the NIE. The table shows that transaction costs and property rights were "voted" for by the editors of all six volumes illustrating the same principles as neoclassical economics (methodological individualism and individual rationality) taking into account that institutions matter as we live in a word of incomplete information (Richter 2005: 165-70). Most of the six volumes are concerned with macro issues (three with issues of development economics, one with new institutional economic approach to history, another one with issues of evolutionary economics and only one issue include micro economic problems).

12. Basic representatives of NIE

NIE traces its origins to Coase's analysis of the firm (Coase, 1937), Hayek's writings on knowledge (Hayek, 1937, 1945) and Chandler's history of industrial enterprise (Chandler, 1962), along with contributions by Simon (1947), Arrow (1963) and Davis and North (1971). It began to develop as a self-conscious movement in the 1970s through the works of Williamson (1971, 1975, 1985), North and Thomas (1973), North (1981, 1990), Alchian and Demsetz (1972), Macneil (1978), Holmström (1979) and others. Its best-known representatives are Coase, Williamson and North (Pratten 1997:784).

12.1. Coase: Transaction Costs and the Theory of the Firm

> "Modern institutional economics should study man as he is, acting within the constraints imposed by real institutions"
>
> Ronald H. Coase (1984:231)

Coase argues that the subject matter of economics is the study of the working of the economic system, a system in which people earn and spend incomes (Coase 1998:72).

The main theoretical contribution of NIE is considered to be the concept of transaction costs. The general hypothesis of this strand is that institutions are transaction cost-minimising arrangements. It originated from Ronald Coase's (1937:388) article where he argued that market exchange is not costless and posed the following question:

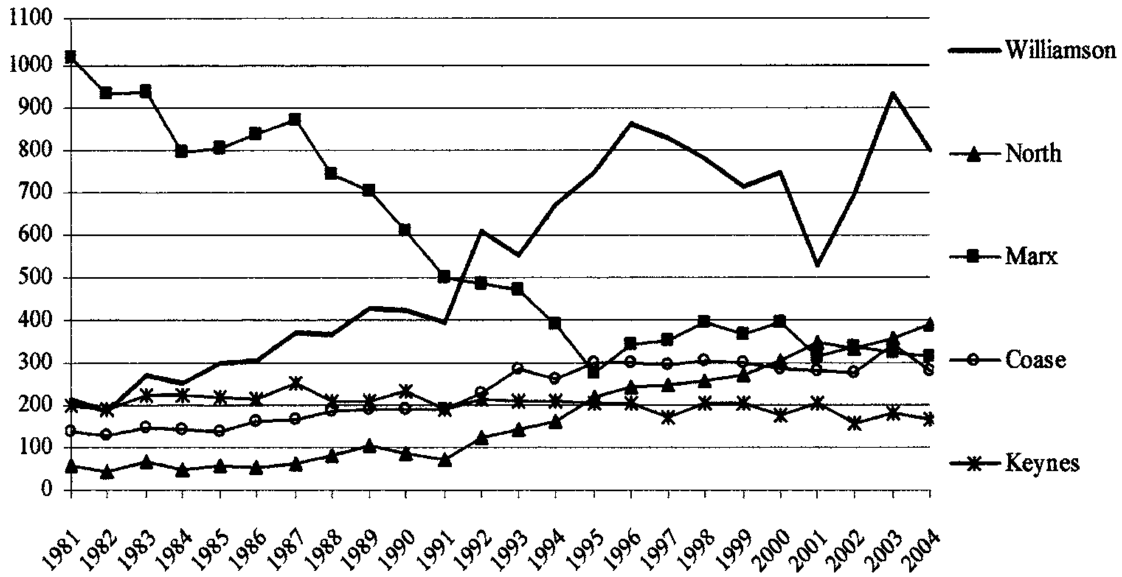
> But in view of the fact that it is usually argued that co-ordination will be done by the price mechanism, why is ... organisation necessary? Why are there these 'island of conscious power'? ... Yet, having regard to the fact that if production is regulated by price movements, production could be carried on without any organisation at all, well might we ask, why is there any organisation?

While he did not coin the specific term, Coase does refer to the "costs of using the price mechanism" in his 1937 "The Nature of the Firm" where he first discusses the concept of transaction costs, and also refers to the "Costs of Market Transactions" in his other seminal work, "The Problem of Social Cost" (1960) (Pitelis 1998:999). In his classic paper Coase put forward the idea that transaction costs are the key to firms, and that firms are created because their transaction costs are lower than are the costs of using the price mechanism for allocating resources.

Definitions about transaction costs vary. North (1990: 28) for example defines transaction costs as 'the costs of defining, protecting and enforcing property rights', while Williamson (1985: 18-19) uses Kenneth Arrow's definition of TCs as 'the costs of running the system', in 'analogy to friction in physics'. Transaction costs have been broadly defined by Steven N. S. Cheung (1983) as any costs that are not conceivable in a "Robinson Crusoe economy"—in other words, any costs that arise due to the existence of institutions. He writes 'The determination of the piece-rate – a price – illustrates the costs of "discovering" prices'. Eggertsson (1990: 14), on the other hand, claims that 'transaction costs are opportunity costs just like any other costs in economic theory...'. Finally, according to Dahlman (1979:147-148), a workable concept of transaction costs would be the following "TCE includes the search and information costs, bargaining and decision costs, policing and enforcement costs".

As time goes by, TCE became more established through Oliver Williamson's work (1975, 1985). The work of Williamson on the economics of organisation and contracts follows Coase's line of thinking. Williamson's impact on the theory of TCE and on economic organisation is recognised by scholars in the field and beyond and clearly illustrated by citations to his works (Figure 2) (Pessali 2006:46).

Figure 2 Citations to some prominent economists



Source: SSCI – ISI; hard copy and electronic versions.

Being documented in several publications, Williamson's transaction cost economics rests on two behavioural assumptions: bounded rationality and opportunism. Bounded rationality refers to the fact that individuals are assumed to be 'intendedly' rational, but only 'limitedly' so. People have limited memories and limited processing power. We can't assimilate all the information at our disposal, we can't accurately work out the consequences of the information we do have. Williamson regards opportunism as an extension of the conventional assumption that economic agents are guided by considerations of self-interest. Opportunistic behaviour often is strategic behaviour in which agents pursue selfish goals 'with guile' as Williamson puts it. That is, people may not be entirely honest and truthful about their intentions, or they might attempt to take advantage of unforeseen circumstances that gives them the chance to exploit another party.

The real explanatory power of the theory, though, comes from the three dimensions or variables that are used to characterise any transaction. Transactions can be frequent or rare; have high or low uncertainty; or involve specific or non-specific assets. These three variables will, according to the theory, determine whether transaction costs will be lowest in a market or in a hierarchy. It is easiest to consider these variables with respect to decisions about whether to integrate vertically. Frequency is the most easily dealt with. There will never be a situation in which a firm would want to integrate vertically so as to bring "in-house" the provision of a good or service that is very rarely used. Concerning uncertainty the issue here is how hard is it to foresee the eventualities that might occur during the course of the transaction. One obvious factor here is the length of time over which the transaction will take place. Transactions that take place on "spot markets" will have relatively little uncertainty, because one doesn't have to predict the future. On the other hand, transactions that involve a commitment over some time have some uncertainty built in to them. Last but not least, asset specificity is perhaps the most important element in Williamson's theory. He argues that where transactions involve assets that are only valuable (or are much more valuable) in the context of a specific transaction, transaction costs will tend to be reduced by vertical integration (Williamson 1985:16).

Nowadays, TCE are used to explain a number of different behaviours such as buying and selling, but also day-to-day emotional interactions, informal gifts exchange, etc. The transaction cost approach is now more microanalytic, more conscious of its assumptions with regard to behaviour, regards the firm more as a governance structure for contracts than as a production function and places greater weight on the ex post arrangements of contracts, particularly on private arbitration in comparison to court justification (Williamson 1985:18).

12.1.1. <u>The "as if" economy</u>

According to Williamson the choice of initial conditions serves uniquely to stress some particular aspects of the relations among the institutions of capitalism, but does not influence their theoretical understanding (Ankarloo and Palermo 2004:413). In *Markets and Hierarchies* the basic TCE framework is presented with the initial assumption that 'in the beginning there were markets'. This key stance deserves prompt justification. Williamson opines (1973:320-21):

> I assume, for expositional convenience, that 'in the beginning there were markets.' This choice of initial conditions results in what may appear to be a preoccupation with market failure. In fact, however, organisational failure is a symmetrical term meant to apply to market and nonmarket organisations alike. . . were the initial conditions to have been reversed, so that 'in the beginning there was central planning', the analysis would appear instead to be preoccupied with internal organisational failures. In either case, the same organisational failures framework would be employed.

Furthermore, as TCE gained the limelight more historically oriented economists and other social scientists started calling to account the historical and logical properties of this assumption. Williamson addressed the issue again only in *The Mechanisms of Governance* (1996) (Pessali 2006:49). Lately, in an interview being conducted by Hodgson and Gindis, Williamson answered that "the main reason for this statement of mine is that we've got to start the analysis somewhere. We could start with the neoclassical theory markets and market failures and interpret hierarchies as a response to market failures. But a sociologist might start with hierarchies and hierarchical failures and interpret markets as a response to hierarchical failures. I think, however, that the literature on markets and market failures is in a lot better shape than the theory of hierarchies and hierarchical failure. In that event, viewing hierarchies as a solution to market failures is a more natural way to go" (Williamson 2007:379).

So, this claim need not be true as it depends on the definition of the market and the firm and also on the context and timing, whether we refer to a particular historical context or to the first emergence of firms or markets. For instance, Coase argued that markets and firms differ as the former rely on the voluntary transactions between individuals whereas the latter count on the authority of one party over the other (the entrepreneur over the employee). If we accept this definition the question which arises refers to the context and timing one chooses for the beginning. Is it the beginning of a specific historical period or of life in general? This is something very important because if we consider that the Coasean type of firm emerged in the capitalist era one would be more willing to accept the idea of pre-existing markets. On the other hand, if somebody starts from the very beginning then undoubtedly this assumption is false. Following the emergence of the human race at first the individual was self sufficient and if we start from this then we have to explain why individuals 'left' a world of zero transaction costs (no exchange) for a world of positive transaction costs (exchange) (Pitelis 1998: 1004).

The answer to this question could be the following. Without transactions and their relevant organisations, it would be impossible to take advantage of the division of labour or of innovative technologies. What is more, in a world of positive transaction costs, the allocation of resources and the development of new technologies depend on the prevailing governance structures, i.e. the modes for organising transactions, and on the characteristics of users' rights, particularly property rights. Hence, incorporating positive transaction costs necessarily involves institutions (Menard 2001:86).

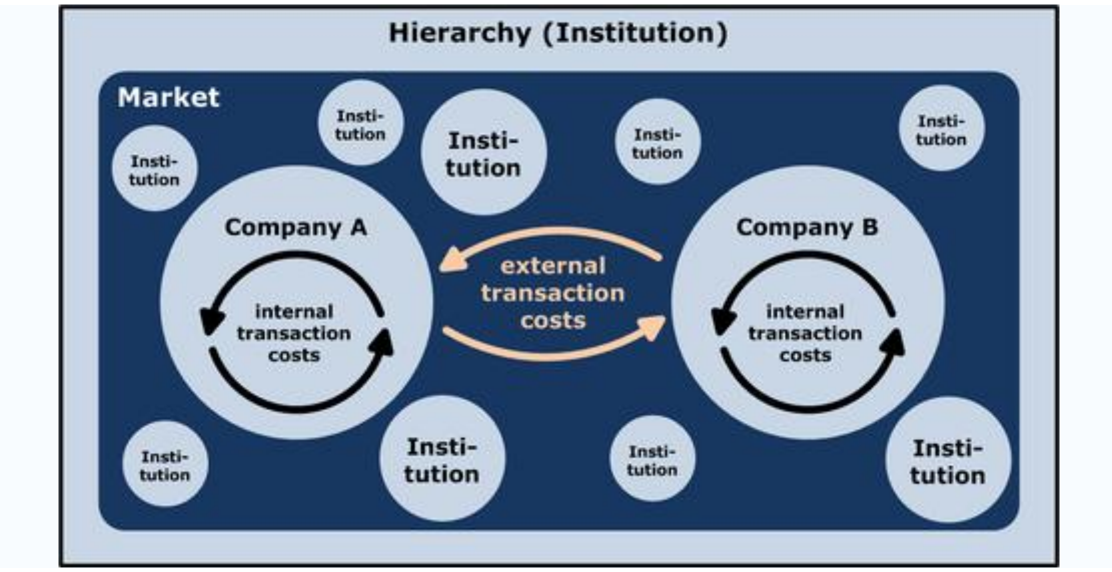
With reference to the previous comments, Engels argues that 'production may occur without exchange, but exchange cannot occur without production' (Engels 1976:186). Logically, the firm precedes the market, not vice versa. Otherwise there would be nothing to exchange. So the idea that the market is the original institution is inconsistent: markets cannot exist without institutions that solve the production problem (Hodgson 1993:81-82).

Summarising, Williamson through relevant exercise in comparative statics tried to explain the economic role of other institutions. The general method consisted of introducing non-market institutions every time the market fails to allocate resources efficiently. The problem involved in the assumption that in the beginning there were markets revealed the origins of the inner contradiction of the NIE research programme. The market presupposes the existence of the firm as the exchange presupposes the production. So the statement that 'in the beginning there were markets' is incoherent, even if justified by expositional purposes (Zald 1987:706).

12.1.2. <u>The Theory of the Firm</u>

Coase refers to firms as the "islands of conscious power in this ocean of unconscious co-operation" (Rajan and Zingales 1998:387). Indeed, until 1937 economics had not yet provided a clear cut definition of the firm. Firm behaviour was equated with the behaviour of the entrepreneur. What goes on within firm remained in the dark and as we have already noted for many years the neoclassical approach suggested that the firm was just a "black box" transforming inputs into outputs and nothing would be gained from analysing it. It was enough for us to know that the purpose of the firm was to maximise profits. In 1937 Coase starts with the remark that economists tend to think of the economic system as an organism that is being coordinated by the price mechanism. Yet, he argues, this way of thinking is not appropriate when considering what goes on inside organisations like firms. Within firms, voluntary exchange transactions are replaced by obeying the directions of the 'entrepreneur- coordinator'. The employees working within a firm are not guided by any price mechanism. Coase then poses the fundamental question of why do firms exist at all and answers this question giving the following explanation: "the main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism" (Coase 1937:386).

<u>Figure 3 Transactions in firms or in markets</u>



The above model shows institutions and market as a possible form of organisation to coordinate economic transactions. When the external transaction costs are higher than the internal transaction costs the economic activity will take place inside the 'skin' of the firm. If the external transaction costs are lower than the internal transaction costs the economic activity will take place in the market.

Williamson's work starting in the early 70's brought the theory of the firm back to life. After Coase's path breaking 1937 paper and before Williamson's contributions, very little happened in the theory of the firm. Among economists the small amount of work that did take place in this period was, by and large, ignored. Then came Williamson (Hodgson 1999:243). For Williamson, the existence of firms derives from 'asset specificity' in production, where assets are specific to each other such that their value is much less in a second-best use. This causes problems if the assets are owned by different firms (such as purchaser and supplier), because it will lead to extended bargaining concerning the gains from trade (Williamson 1973: 320).

Meanwhile, Alchian and Demsetz in an effort to build on the work of Coase and move the theory forward, have suggested a somewhat different explanation of the firm. According to Demsetz (1997:426) "the development of the theory of the firm has recently undergone a 'quiet revolution' ". One of the main purposes of this new theory is to shed light on the internal organisation of firms. The neoclassical theory was concerned with prices and output. The new theory, on the other hand, is interested in different ways of organising transactions. To be more specific, their purpose is to "explain the conditions that determine whether the gains from specialisation and cooperative production can better be obtained within an organisation like the firm, or across markets, and to explain the structure of the organisation" (Slater and Spenser 2000:62). According to Alchian and Demsetz (1972:783):

> We do not disagree with the proposition that, *ceteris paribus*, the higher is the cost of transacting across markets, the greater will be the comparative advantage of organising resources within the firm; it is a difficult proposition to disagree or to refute. We could with equal ease subscribe to a theory of the firm based on the cost of managing, for surely it is true that, *ceteris paribus*, the lower is the

> cost if managing the greater will be the comparative advantage of organising resources within the firm.

Both Coase and Alchian and Demsetz view the firm and the market as potentially alternative means of organising production. This view of the firm, as an alternative to the pricing system, is shared by others, among them Keneth Arrow, for whom the firm is one of a number of "organisations which are means of achieving the benefits of collective action in situations in which the price system fails" (Arrow 1974:33, cited in McNulty 1984:235).

In classical and neoclassical economics markets are the centre of the stage and households, consumers, firms, owners of resources and governments are the actors of the play (Simon 1991:25). A large part of the economic activity now takes place inside the "skin" of the firm and this fact raises two questions. Firstly, why do not all the 'self-employed' remained independent contractors and, secondly, how are employees motivated to work for the maximisation of the firm's profits as most producers are employees not owners and they have no reason to maximise a firm's profit, except to the extent that they can be controlled by owners? The simple neoclassical answer to the latter question is that motivation derives from the employment contract[10] under which employees maximise their utility accepting the rules of the firm (Simon 1991:26). Also, another answer to the motivational question could be that employees may be motivated to accept authority by giving them material rewards, promotion and recognition. Such rewards certainly provide

[10] The **employment contract** is an example of what is now sometimes called "an incomplete contract", that is to say, some of its terms are unspecified. Employees agree to do over the life of the contract what they are ordered to do but the orders will not be issued until some time after the contract is negotiated (Simon:1951 ; Williamson:1975, cited in Simon 1991:31). The essential point is that the uncertainty for the employer is decreased by delaying the commitment to specific actions from the time employment begins until the time when action is called for.

motivation but there is the problem that the employee's contribution to the organisation's goals must be measurable with reasonable accuracy.

12.2 Douglass North and his role in New Institutional Economics

"Our biggest challenge is to understand economic change. First, we should develop a theory of institutions and we should start to rethink fundamentally what economics is about."

Douglass C. North (2005:xi)

According to Milonakis and Fine (2007:27) "Douglas North is one of the most influential economic historians of our times". He shared the 1993 Nobel Prize in economics with Robert Fogel "for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economics and institutional change"[11].

In the early 1960s, North founded cliometrics, along with other, which applies economics and quantitative methods to the study of economic history (named after Clio, the muse of history). Although in its earliest phases North supported Cliometrics he then became increasingly critical.[12] Douglass North worked in the New Economic History roughly from the late 1950s through the 1960s. He served as co-editor of the Journal of Economic History with William Parker from 1960 to 1966 (Stromberg 2002:107).

One of his early major outputs of his work was his 1961 book *The Economic Growth of the United States from 1970 to 1860* showing how

[11] See http://nobelprize.org/nobel_prizes/economics/laureates/1993/index.html

[12] By the 1970s, a clear separation between North's vision and that of the cliometricians had come into view.

one sector of the economy stimulated economic developments in other sectors. In 1968 North published an article showing that organisational change was more important than technological change. Throughout the 1970s, North published books and articles showing that institutions, especially well-developed property rights are significant in explaining economic growth of Western countries and why performance inequalities between them can be explained. This explanation was his central task in his post-cliometric phase. He opines that "institutional change shapes the way societies evolve through time and hence is the key to understanding historical change" (North 1990:3). North went further, hypothesising that 'profits', with the widest meaning of the term, in order to be higher should be accompanied with the proper institutional framework otherwise there is no possibility to achieve the desirable level (Milonakis and Fine 2007:29).

The development of political framework to explore long-run institutional change occupied North during all of the 1980s and led him to the publication of *Institutions, Institutional Change and Economic performance* in 1990 in which he tried to tackle the subject of rationality and how people make changes (under what conditions and constraints). This question was fundamental for North in order for the social sciences to make further progress. Having in mind the free rider problem he questioned why people would obey the rules of society when they can follow their individualistic instinct and cheat, steal or assault in order to achieve better results for them. In order to solve this contradiction, North (1991:109) introduced the term "ideology" which is "the subjective perceptions all people posses to explain the world around them" and presented it as the solution of this problem.

A key concept in North's work on institutions is the existence of transaction costs. In a world with complete information and instrumental rationality[13], institutions, ideas and ideologies don't matter. But as a

[13] In social and critical theory, **instrumental rationality** is often seen as a specific form of rationality focusing on the most efficient or cost-effective means

matter of fact, we live in a world of incomplete information and limited mental knowledge. North (1995:9) opines:

> The cost of transacting, to put it in it bluntest form, is the key to economic performance. When I go to Third World countries and look at why they perform badly and examine how factor and product markets are really working, in every case, be it capital, labour or product markets, one observes that the cost of transacting is high. The cost of transacting results in the economy performing badly because it is so costly for human beings to interact and engage in various kinds of economic activity that the result is poor performance and poverty and so on. Where this takes us, of course, is to try to understand why the cost of transacting is so high.

So, since 1990 his research has been directed toward dealing with this issue. North (1990:3) defines institutions as:

> The rules of the game in society or, more formally, the humanly devised constraints that shape human interaction [and which] in consequence structure incentives in human exchange, whether political, social or economic.

12.2.1 North and Economic History

North's early work was in American economic history centered on the economics of location and the costs of transportation. He stressed the "export-led" character of American economic development at the local

to achieve a specific end, but not in itself reflecting on the value of that end. Thus, to the extent that rationality is concerned with critically evaluating actions, instrumental rationality tends to focus on the 'hows' of an action, rather than its 'whys'.

level. Later, North presented a regional model of nineteenth century American economic development. He also focused on the use of government by economic interests seeking to channel trade in their direction or to lower artificially their existing transportation costs (Stromberg 2002:105).

North pioneered the New Economic History in an attempt to explain how economies evolve through time. This is considered to be the more macro aspect of the NIE, which looks at the role of institutional change in fostering overall economic growth and explaining the differences in the development of various countries. According to North, institutions that evolve to lower transaction costs are the key to the performance of economies (North 1994:361). For North, path dependency and history are important in explaining institutional development. North opines that not all institutional changes are beneficial. In fact, by influencing transaction costs and co-ordination possibilities, institutions can have the effect of either facilitating or preventing economic growth. That explains for example why we have various institutions that develop in different countries and why we have different paths of economic development. There is a sort of two-way causality between institutions and economic growth. On the one hand, institutions have a profound influence on economic growth, and on the other hand, economic growth and development often result in a change in institutions. Furthermore, North argues that two significant factors for institutional change are changes in relative prices and technological innovations. Historically, population changes are seen as the most important source of relative price changing whereas in recent years, technological change and changes in the costs of information are becoming major sources of institutional change.

As tribes evolved in different environments, they learned different languages which enable them to explain the world around them. These different attitudes helped to form the institutional framework of the tribe and were passed down as customs, taboos, and myths that became what we call 'culture'. As specialisation and division of labour matured in the economic activity, the tribes evolved into polities and economies. The diversity of experience and learning produced increasingly different societies and civilisations leading to a different way in solving the fundamental economic problems of scarcity. The reason is that as the complexity of the environment increased as people became increasingly interdependent, more complex institutional structures were necessary to capture the potential gains from trade. Such evolution requires that the society develop institutions that will permit anonymous, impersonal exchange across time and space (Fiori 2002:1033).

12.2.2. Critique of North

It is argued that North and new economic historians in general, are using models and concepts that are ahistorical, asocial, timeless and universal. Can someone put the blame on its connection with the neoclassical theory? Are these allegations exaggerated and don't appreciate the fundamental contribution of North's work and of New Institutional Economics?

The "accusations" for North's a-historicism can be focused in three subject matters: his individualistic perception about social phenomena, his commitment to neoclassical type analysis and his use of universal and timeless concepts to all types of societies. For a Nobel Laureate economic historian these are serious charges. To begin with, methodological individualism represents a cornerstone of North's work. As it is pointed out 'the individual is the source of everything' (Milonakis and Fine 2007:30). Focusing on the individual means automatically the exclusion of the social and of the history that goes with it. But what should be emphasised is that when we begin from the social we can explain the individual's actions but the inverse it is not possible. For instance, "collectives and groups have history; individuals don't" (Zouboulakis 2005:144). This controversy is like the puzzle of which came first «the chicken or the egg?».

The second crucial claim against North's ahistoricism concerns his strong commitment to neoclassical economics. Although he rejects the assumption of perfect rationality and complete information, he argues that institutions are the result of optimising behaviour of individuals who respond to changes in the set of relative prices. Last, but not least, concerning the third "accusation", it is said that North used the very same terms for all societies as if they were ruled by the same capitalistic logic. But this approach is in complete contrast to his opinion that the key of the evolution of a society is a dynamic process which takes place through changes in institutions. If North really believed that the same logic in individuals' decisions prevail in every society, then what makes the existence of institutions, ideas and ideologies necessary? This is a contradiction that North himself realised and since 1990 exploring the culture of a specific society, became the central task in his research. He argued that economic performance is the outcome of a complex process of playing the economic game according to formal and informal rules that provide incentive structures and channel innovative activities in a certain direction (Mantzavinos, North and Shariq 2004:83).

Although North's contribution to New Institutional Economics and in general terms to the relationship between economics and social sciences is undeniable, North's work remains attached to the basic principles of neoclassical economics and especially to that of methodological individualism considering everything as the result of the rational action of individuals. He tries to combine the neoclassical main assumptions of rationality and individualism with the institutional framework unsuccessfully. We have not got an essential transformation of the hard core technical apparatus towards a more social and historical way of thinking. Universalistic and ahistorical concepts such as transactions costs are used to explain the existence of the firms without taking into account the historical dimension of their emergence.

What is more, North's lack of realism about states is staggering (Fine and Milonakis 2003:557). According to North (Mantzavinos, North and Shariq 2004:78) "states exist because they provide individuals with solutions to the twin problem of trust and protection from aggression. A state emerges once a society grows bigger and relationships among the members become increasingly impersonal… In a large society, for instance, with its advancing impersonalisation, it is sufficient for the process of state emergence to begin if a creative individual starts cheating on the promises given by the rest of the group members, realising the potential benefit of defection. Others will imitate him and after some time, an increasingly large number of free riders will come to be". Ideas, even interests, are left somewhat in the historical sidelines by this approach. In the end, "models" rule the Northian world, and purposive individuals vanish. If necessary, "ideology" will be introduced, but only as another "variable" (Stromberg 2002:118).

According to North "what we are trying to do is not to replace neoclassical theory; we are trying to make it applicable and useful to individuals. We have to start all over again to understand how societies evolve as rules, the stock of knowledge, the demographic features change as time goes by" (North 2000:9). The way in which institutions change reflects the beliefs people have; and the beliefs people have require that we understand how human beings learn, what they learn, what they believe. For instance, why did beliefs such as Communism get accepted the way they did? Thus, beliefs were translated into institutions, and institutions were translated into the way economies evolve over time.

12.3 The New Institutional Framework: Williamson's theoretical approach

"New Institutional economists are the blue-collar guys with a hearty appetite for reality"

Oliver E. Williamson (2000a)

When seeking to examine the role of "social, cultural, political, and economic institutions" on "economic behaviour and performance" one has to choose among the different fields to be involved in the study of institutionalism. As I will discuss presently, new institutional economics has not tried to focus on all institutions that might fit under this umbrella. Nor has it focused on all aspects of economic performance. To understand the boundaries of new institutional economics better, it is useful to separate the general institutional framework into subsections, by analysing each one individually and then trying to find the interconnections between them.

The most useful framework to work with is the one proposed by Oliver Williamson (2000b). I will make use of Williamson's analytical framework here, including a number of adaptations of my own. Williamson's framework identifies four interrelated levels of social or institutional analysis (Figure 4).

Figure 4 Levels of Social Analysis

ECONOMICS OF INSTITUTIONS

LEVEL	FREQUENCY	PURPOSE
L.1 **EMBEDDENESS:** **Informal Institutions, Customs, Traditions, Norms, Religion**	10^2 to 10^3	**Often noncalculative spontaneous**
L.2 **INSTITUTIONAL ENVIRONMENT:** **Formal Rules of the game-property(polity, judiciary, bureaucracy)**	10 to 10^2	**Get the institutional environment right. 1rst Order Economising**
L.3 **GOVERNANCE:** **Play of the game-contract(aligning governance structures with transactions)**	1 to 10	**Get the governance structure right. 2nd Order Economising**
L.4 **RESOURCE ALLOCATION AND EMPLOYMENT:** **(prices and quantities; incentive alignment)**	Continuous	**Get the marginal conditions right. 3rd Order Economising**

L.1: Social Theory

L.2: Economics of Property Rights

L.3: Transaction Cost Economics

L.4: Neo-classical Economics/ Agency Theory

Four levels of social analysis are presented it the figure above. The solid arrows that connect a higher with a lower level mean that the higher level imposes constraints on the level immediately below. Whereas the reverse arrows that connect lower with higher levels mean feedback. The NIE has mainly concentrated on action at levels 2 and 3.

The top level is the level of social embeddedness, social ingrainedness. It is the level in which the norms, customs, mores, traditions are located. Also religion plays a vital role. Level 1 is considered as given by most economists. Institutions at this level change very slowly (centuries of millennia) with adaptation periods of as long as a thousand years and no shorter than 100 years. The problems related to this level are treated by Neil Smelser and Richárd Swedberg in the introduction of their book with the title 'Handbook of Economic Sociology', in which they state that 'the concept of embeddedness still needs a lot of theoretical specification'. There is a question of why informal[14] institutions have such a widespread influence upon the long-run character of economics. Many of these informal institutions have mainly spontaneous origins. It is commonly believed that informal institutions, such as norms and customs, change relatively slowly, and therefore, in studies involving marginal changes in

[14] **Informal rules** are traditions, customs, moral values, religious beliefs, and all other norms of behaviour that have passed the test of time. Informal rules are often called the 'old ethos', the 'hand of the past', or the 'carriers of history'. They embody the community's prevailing perceptions about the world, the accumulated wisdom of the past, and a current set of values. Thus, informal institutions are the part of a community's heritage that we call *culture* (Pejovich 1999:166).

formal rules, informal institutions can often be taken for granted. Yet changes in informal institutions must be considered in studies with a long time horizon or studies of large-scale changes in economics systems, such as the evolution of efficient market economics (Eggertsson 1990:12-13). This level does not serve any calculative purpose. While these rules are the product of the goals, beliefs and choices of individual actors, the social result is typically not known or 'designed' by anyone.

The second level is the institutional environment. The structures here are partly results of evolutional processes, but here already appears the possibility of sense of purpose. If we overstep the level 1 type 'informal constraints' (sanctions, taboos, conventions, traditions, etc.), we get to the 'formal rules of the game' (constitutions, acts, proprietary rights) (Williamson 2000:598). The institutional environment forms the framework in which human action takes place. 'Institutions reduce uncertainty by providing a structure to everyday life' (North 1990:3). It includes the background constraints that guide individuals' behaviour. These constraints are formal[15] (constitutions, laws, property rights). The policy, judiciary and bureaucracy are located here. Institutional arrangements are specific guidelines designed by trading partners to mediate particular economic relationships. Business firms, long term contracts, public bureaucracies, non-profitable organisations and other contractual agreements are examples of institutional arrangements. The structures observed here are the product of politics and provide the rules

[15] **Formal rules** are constitutions, statutes, common law, and other governmental regulations. They determine the political system (i.e., the governance structure and individual rights), the economic system (i.e., property rights and contracts), and the enforcement system (i.e., the judiciary and the police). Governmental authorities enforce formal rules by means of sanctions such as fines, imprisonment, and execution (Pejovich 1999:167).

of the game according to which economic activity is organised (Torok 2005:55).

The nature of the basic institutional environment at any point in time is reflected by other things from the attribution of a society's basic social and cultural foundation. Changes in the basic institutional environment now occur more quickly than changes in the cultural or social foundation (Level 1), but change is still relatively slow and partially constrained by the slow rate of adaptation of the underlying social and cultural foundations, with response time as short as 10 years but as long as 100 years (Williamson 1998b: 77). Although these are unquestionably important with respect to the productiveness of an efficient economy a progressive type, always accumulative change is hard to keep in check. Mass-dissatisfaction, civil war, or the occupations after the Second World War, collapses (Eastern-Europe and the former Soviet Union), military putsch (Chile), or a financial crisis (New-Zeeland) – cause on occasions very significant breakage in the acclimatised forms (Furubotn and Richter 1991:40).

As I have mentioned, the property rights can be put onto this level, and the researches related to its financial part were characteristic to the 1960's. One of the central topics of the institutional economics is the property structure. A competitive market ensures the freedom of the private property and the contract. Under properties we understand everything, which brings profit, or causes satisfaction in the widest sense. However, in order to realise this satisfaction, the individual must possess the property. The proprietary right is exclusive to the effect that it can only be restricted by persons being entitled by the rule of law (or the proprietor him-/herself).

Beyond the laws of game (property) the course of the game (contract) also needs to be taken into consideration. Here we get to the control of the contractual relations in the 1970's . And this leads us to level 3, where the institutions of control and lead are to be found. The third level is where institutions of governance are located. According to Williamson this is the "play of the game". What Williamson calls a governance structure is to protect the transacting parties from various hazards associated with exchange. It is true that the legal environment has received the most attention. Economists have long been interested in the economic effects of laws but only in the last few decades has economics been applied to the design of legal rules and the legal system itself. Property still remains important. Transaction costs economics operates at level 3. As it was stated before in level 2 there are the rules of the game whereas level 3 deals with the play of the game. Second order economizing applies: get the governance structures- market, hybrids, firms, bureaus- right (Klein 1999:458).

The basic structural features of the institutions (e.g. competitive markets) through which individuals trade goods, services and labour, the structure of contractual/transactional relations, the vertical and horizontal structure of business firms and the boundaries between transactions mediated internally and those mediated through markets, corporate governance, and financial institutions that support private investment and credit, are defined at this level. Changes in governance arrangements also take place more quickly than do changes in the basic institutional environment. Williamson suggests a change time frame of one to ten years (Williamson 1998a:28).

Level four includes marginal analysis. This is the level with which neoclassical economics and agency theory has been concerned. The neoclassical decision variables are price and output. This level refers to the day-to-day operation of the economy given the institutions defined at the other three levels. Prices, wages, costs, quantities bought and sold are determined here as are the consequences of monopoly, oligopoly and other neoclassical market imperfections.

The division of social, political, legal and economic institutions into four levels can be characterised as somewhat arbitrary. However, I think that this qualitative characterisation is quite useful. A society's social and cultural foundations place constraints on the attributes of the basic institutional environment that will be feasible at a particular point in time. For example, societies that have no tradition of private property and have relied instead on communal exploitation of resources and collective allocation decisions cannot be expected to adopt successfully the basic institutions of capitalism that characterise the U.S. or Western Europe overnight. Nor will societies with hierarchical non-democratic political systems, easily shift instantly to modern democratic political or human rights institutions.

Williamson's framework also makes it clear that performance is a relevant factor for the speed of change. Good performance supports the status quo. Poor performance stimulates change, but not always in a direction that makes thing better overall. Another contributing factor is that changes in lower level institutions in the hierarchy can stimulate changes in higher level institutions. It is my personal belief that transactions or trade relationships between all involved would be increased for the better if a trusting institutional framework was already in place. Whatever the pathways of change, both the speed and nature of any changes will necessarily be affected by the time that it takes to make significant adjustments in the attributes at the different levels of this institutional hierarchy.

New institutional economics has focused primarily on analyses of aspects of institutional arrangements that fall in level 2 and level 3 of this hierarchy (or both). At International Society for New Institutional Economics' annual conference in 2003 about 85% of the papers presented fell within these categories and were divided roughly equally between them. Only 5% of the papers were on topics that would be categorised as level 4 (and some of these featured applications of experimental economics), while about 10% involved issues on level 1 of the hierarchy, focused heavily on the role of religion, ethics and social norms (Dequech 2002:570-71).

13. Critique of New Institutional Economics

Although NIE presents itself as a theoretical approach trying to solve the problems associated with the non-realistic, asocial and ahistorical foundations of the neoclassical economics, it rests on unsolvable contradictions. New Institutional Economics has its flaws and weaknesses. Most critics have focused on methodological issues. On the one hand, heterodox economists attack primarily the assumptions made, particularly the idea that economic agents are in some way calculative since they are assumed to have a bounded rationality. On the other hand, the lack of adequate models is the main critique leveled by mainstream economists against NIE.

According to neoclassical economists, models are essential because they transform central concepts, which are highly abstract and apply to a very large class of phenomena, into explanations with a predictive power for more limited sets of specific phenomena. That is, models are necessary 'intermediaries' between the development of a pure theory and its application to the analysis of empirical facts. They are also crucial in determining the capacity to measure which is a central goal in science. From this point of view, two characteristics are of particular importance: the predictive power of propositions established by a model and the extension of the set of 'facts' to which these predictions apply (Menard 2001:86).

13.1. Theoretical Problems of NIE

Do the concepts of NIE help in making a positive contribution to economic theory? As stated before, TCE is a key feature of NIE. The question arising is if the distribution of resources can be conducted via the price mechanism, then why did a 'non-market' institution such as the firm emerge? The concept of transactions costs is inconsistent in relation to the very basics of the neoclassical theory. There is a deeply problematic relation between the concept of transaction costs and that of price mechanism. It is the fact that prices do not reveal all the necessary information for a market to operate in an efficient way. This means that individuals do not have all the necessary information in order to make rational economic calculations. These limits of the price mechanism are recognised by the theorists of NIE and the only way to confront this problem is to assume that individuals act and make cost-benefit decisions without knowing the prices (Frauenford 2007:39).

What is more, there is a methodological schizophrenia on the foundations of NIE. Although NIE assumes that we live in a world full of transaction costs, uncertainty and limited knowledge, it starts adopting the neoclassical assumptions which exist in a frictionless framework. Something else very important is the fact that if we accept that transaction costs exist in a world where there are no institutions then we cannot at the same time admit that transaction costs are the cause of institutions in general. We arrive at the conclusion that transaction costs are dependent upon institutions (Menard 2001:86).

Another part of the critique concerns Williamson's assumption that "in the beginning there were markets" as it was mentioned already. According to Ankarloo (2006:17) where there is economics in NIE there is no-history and where there is history in NIE there is no economics. The assumption that "in the beginning there were markets" Ankarloo calls it the "as if" economic theory. Williamson's historical analysis can be characterised as 'peculiar' because the statement that capitalist institutions originated without coercion is not documented historically (Ankarloo and Palermo 2004:418). Williamson's arguments are conducted deductively rather than historically. He is forced to invent a course of history whose realism in historical terms is immaterial to the validity of the model. Effectively disregarding serious historical research, Williamson is forced to tell a story that simply tries to fit his theory. He does not try to explain actual events, but only illustrates a possible historical development. In Williamson's theory, as in NIE at large, history is treated as if it did not matter to the conception of the model. But since hierarchical organisations of production in history preceded a system of markets, feudalism preceded capitalism etc. are historical products, the assumptions of Williamson's theory inevitably land him in trouble. If markets are assumed to exist prior to selection, nobody historically could have chosen them for their efficiency. Alternatively, if markets are seen as consciously chosen, markets cannot be seen as the unintended 'spontaneous' result of evolution or a social 'natural selection'. As a result of this, Williamson is caught in the middle (Ankarloo 2006:11)

14. Concluding Remarks

Economics has long seen itself as a relatively autonomous science with its own distinctive set of characteristics that make it a 'separate' science (Hausman 1992, cited in Davis 2008: 12). But recently the issue of economics' boundaries and separateness from other fields has come under scrutiny. The current situation within the discipline of economics reflects a disciplinary schizophrenia. On the one hand, within the discipline, there is an absolute confidence that the technical apparatus is able to explain every social aspect. On the other hand, there is an increasing and widening recognition within economics that the economy cannot itself be understood on the basis of economic variables alone (Mauroudeas 2006, cited in Fine 2007:9)

Economics is an easy subject and a difficult subject at the same time. It is easy in the sense that there are only a few principles that really guide most economic analysis. It is difficult because 'first-class minds' don't give much attention to real-world issues. On the question of whether there are limits to economics as a science, Frank Knight gave us a lead in answering by implicitly delimiting the non-rational realm. He wrote "From a rational or scientific point of view, all practically realm problems are problems in economics" (Knight 1936:105, cited in McKenzie 1979:151). The problem of life is to utilise resources "economically", to make them go as far as possible in the production of desired results. Life is taken up more with defining "wants" than with acting upon given wants.

What is more, the dominance of neoclassical economics for a long period of time and especially until the eighties has overshadowed the development and growth of alternative approaches to economics concerned with analysing, rather than abstracting from, the complexities of economic systems associated with the interaction of economic, historical, social, legal, political, and psychological factors. Within NCE, the problem of the general equilibrium (GE) framework is its inability to explain economic institutions: Institutions can only be taken as given, but cannot be explained as the result of economic processes. The economic system defined is a purely abstract and ahistorical construction. No process can be called upon to explain the emergence and developments of the institutional system assumed.

In recent years this attitude changed as now there has been a growing recognition that providing satisfactory answers to basic research questions—such as what determines the economic performance of companies or countries—requires the development of an interdisciplinary economics that integrates economic analysis with other social sciences (Michie, Oughton and Wilkinson 2002:363). The tumultuous debate on this issue is indicative of a manifest dissatisfaction with the neoclassical thought. NIE emerged as a response to the ahistorical character of the neoclassical economic approach. Although institutions are considered to be the centre of the analysis as in the old institutionalism, NIE uses completely different methodological tools from the old one. As Langlois (1986:5) puts it, "the problem with many of the early institutionalists is that they wanted an economics with institutions but without theory; the problem with many neoclassicists is that they want economic theory without institutions; what the New Institutional Economics tries to do is to provide an economics with both theory and institutions".

New Institutional Economics has achieved considerable credit among the proposed alternatives to the extent of even being commented as the exclusive solution to development (e.g North 1990; Easterly and Levine 2002; Clark 2007; Pejovich 2008, cited in Cojanu 2009:628). NIE is wide-ranging. Particularly, North (1990, 1993, 2005) has in recent years tried to widen the institutionalism of his model to incorporate everything from ideology, culture to law and the state. The economic logic of a system is no longer the cause of development and growth; it is rather the consequence of non-economic constraints (Knight and Sened 1988:10). NIE then represents a specific form of "economics imperialism" by extending the concepts of neoclassical economics beyond traditionally conceived economic spheres to the study of institution. These are for various reasons why it is important to understand the role of institutions: economic stagnation in many developing countries; structural problems in the old industrial economies; and the collapse of the centrally planned economies of the former Soviet Union, Central Asia, and Eastern and Central Europe. Institutional analysis is of paramount importance for guiding the transition to markets in formerly centrally managed economies. Many scholars now recognise that mainstream economic analysis, neoclassical economics, is of little help in restructuring economies missing secure markets (Alston, Eggertsson and North 1996:1).

By expanding the boundaries of economics both in time and space, the NIE casts its eyes beyond the neoclassical horizon, but at the same time it keeps the principles of the mainstream, its firm commitment to rational analysis and methodological individualism. It interprets rationalism as limited (rather than instrumental), taking into account cognitive barriers.

It departs from but does not abandon neoclassical economics. So in this respect it cannot be considered a new paradigm (Rutherford 1989:304). New Institutionalists have been building the protective ring of auxiliary hypotheses around the inflexible mainstream economics.

These lead to an underlying contradiction in NIE, as it attempts to make its economic theory more realistic, more social and more historical in its approach (Immergut 1998:5). The concepts of 'transaction costs', property rights, 'institutions' etc. are invoked in recognition of the limits of the tools of neoclassical static equilibrium theory. History is invoked to support neoclassical economic preconceptions, not in an attempt to build the theory on historical knowledge from the past, but to reinvent history 'as if' it were consistent with neoclassical theory. NIE's 'economics imperialism' is an indication not of the success but of the limits of neoclassical economics. So, the rise of NIE is not a healthy development of neoclassical theory.

Finally, what does an intelligently dispassionate observer of economics nowadays see? In my view one sees an ever expanding technical literature, most of which one cannot comprehend. One sees an almost infinite series of mathematical models that explain diverse socio-economic phenomena as part of some equilibrium scenario which posits autonomous actors being part of the phenomenon under study, often supra-intentionally, through choices that are rational given everyone's beliefs (even when the actions are self-defeating). One sees a series of career paths that are made generously available to those who participate in this global research project. One sees economists the world over being taken seriously only to the extent that they speak this particular 'language'. One sees the powers-that-be speak this very 'language'. Lastly, one sees enterprising academics in other social sciences adopting this 'language' in a transparent bid to share into neoclassicism's discursive success.

We vote, go to church, sing, pray or make love, meet our friends or go on long voyages, not always in order to achieve any further accomplishments or to implement any rational plan of life, but simply to express our sense of ourselves as being the kind of people we are. It seems hard, if not impossible, to account for the phenomena of patriotism, of deep attachment to linguistic traditions and of many sorts of military and political struggle, in terms which appeal primarily to calculation rationality.

Economic theory can only advance if it takes account of historical, cultural and institutional elements. The public is frightened by economics. I believe an economist should try to get people to relax over economics, should express concepts in simple language and show how to deal with important problems in a fairly simple way. The problem with the attempt of rational choice theory to be universally applicable in order to explain all social phenomena is that it fails to focus on specific historical, behavioural, geographical, institutional features of the socioeconomic systems that economists wish to study and understand. As long as generalities limit the explanation of real-world issues, economics will continue to be characterised as ahistorical and asocial, making progress for its own sake, being a 'master' and not a 'servant' of people. An alternative would be an approach to economics that incorporates the social and the historical features (as opposed to universal and timeless, thus dealing with the nature of capital and of capitalism), and addresses issues of class, conflict, power, tendencies, structures, and so on. This will bring economics closer to the other social sciences establishing a proper relationship between them (Fine and Milonakis 2009:177).

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